File No. PCAOB-2005-01
Consists of 358 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rule

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rule

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule, "Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*." The proposed rule consists of an auditing standard, two appendices containing example reports and additional guidance, and a conforming amendment to the Board's interim attestation standards. The proposed rule is attached as Exhibit A to this rule filing.

(b) Not applicable

(c) Not applicable

2. Procedures of the Board

(a) The Board approved the proposed rule, and authorized it for filing with the SEC, at its Open Meeting on July 26, 2005. No other action by the Board is necessary for the filing of this proposed rule.

(b) Questions regarding this rule filing may be directed to Gordon Seymour, Deputy General Counsel (202-207-9034; seymourg@pcaobus.org) or Laura Phillips, Associate Chief Auditor (202-207-9111; phillipsl@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

Section 404 of the Act requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the SEC's implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists. A company may determine that disclosure under the framework already provided by the federal securities laws is sufficient for this purpose. Some 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, adopted an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. <u>Board's Statement on Burden on Competition</u>

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule describes a voluntary engagement that would be available but not required for any company that previously reported a material weakness in internal control over financial reporting. The Board believes that, in some situations, companies will find that auditor assurance that a material weakness no longer exists leads to a higher level of investor confidence in the company's financial reporting and that the costs of the engagement are therefore worth incurring. If a company believes, however, that these benefits may be outweighed in a particular case by the costs, or that the engagement is otherwise not in the company's interest, the company may (and presumably would) determine not to engage its auditor to perform this work.

5. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed Auditing Standard for public comment on March 31, 2005. See Exhibit 2(a)(A). The Board received 30 written comment letters relating to its proposal. See Exhibits 2(a)(B) and 2(a)(C).

The Board has carefully considered all of the comments that it received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rule. The Board's response to the comments it received and the changes made to the proposed rule in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

The proposed rules are not based on the rules of another board or of the Commission.

9. Exhibits

Exhibit A – Text of the Proposed Rules

Exhibit 1 – Form of Notice of Proposed Rule for Publication in the Federal Register.

Exhibit 2(a)(A) – PCAOB Release No. 2005-002

Exhibit 2(a)(B) – Alphabetical List of Comments

Exhibit 2(a)(C) – Written Comments on the Rules Proposed in PCAOB Release No. 2005-002

Exhibit 3 – PCAOB Release No. 2005-015

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: William J. McDonough
William J. McDonough
Chairman

Exhibit A – Text of the Proposed Rule

Auditing Standard No. 4 –

REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST

Table of Contents

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard – *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Applicability of Standard

1. This standard establishes requirements and provides direction that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting (hereinafter referred to as a material weakness) continues to exist as of a date specified by management.

> Note 1: In this context, *previously reported material weakness* means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

> Note 2: The date specified by management as the date that the previously reported material weakness no longer exists must be a date after the date of management's most recent annual assessment.

2. An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist 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*, as of the date of the company's most recent annual assessment of internal control over financial reporting, 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 26 of this standard for additional requirements that apply specifically to a successor auditor's application of this standard.)

Note: References in this standard to the company's most recent annual assessment of internal control over financial reporting apply to the company's most recent assessment of internal control over financial reporting overall, either as of the company's year-end or as of a more recent interim date, as audited by the auditor in accordance with Auditing Standard No. 2.

3. The auditor may report on more than one previously reported material weakness as part of a single engagement.

4. 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 whether a previously reported material weakness continues to exist. 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.

Auditor's Objective in an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

5. The auditor's objective in an engagement to report on whether a previously reported material weakness continues to exist is to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon. The auditor's opinion relates to the existence 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.

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 a material weakness continues to exist.

Conditions for Engagement Performance

7. The auditor may report on whether a previously reported material weakness continues to exist at a company only if all of the following conditions are 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 addresses the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and management's stated control objective(s);

c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

d. Management supports its assertion with sufficient evidence, including documentation; and

e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 48 of this standard.

8. If all the conditions in paragraph 7 of this standard are not met, the auditor is not permitted to complete the engagement to report on whether a previously reported material weakness continues to exist.

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 whether a previously reported material weakness continues to exist, both management and the auditor must use both (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 continues to exist.

> 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.*)

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 states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement to or omission in that relevant assertion is prevented or detected by controls on a timely basis.[1/]

12. 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.

13. In an audit of internal control over financial reporting, the auditor is required to identify the company's control objectives in each area and to identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.[2/]

[1/] See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

[2/] See paragraph 88 of Auditing Standard No. 2.

14. 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

15. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved.

16. A *stated control objective* in the context of an engagement to report on whether a material weakness continues to exist is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing.

17. Because the stated control objective, for purposes of this engagement, provides management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

> Note: When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the related control objectives that are not being achieved may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control

environment would be an example of this circumstance. If management and the auditor have difficulty identifying *all* of the stated control objectives affected by a material weakness, the material weakness probably is not suitable for this engagement and should be addressed, instead, through the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

Performing an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

18. In an engagement to report on whether a previously reported material weakness continues to exist, 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 1: 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.

Note 2: 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, the auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Applying the Standards of the PCAOB

19. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on whether a previously reported material weakness continues to exist. Adherence to the standards involves:

a. Planning the engagement,

b. Obtaining an understanding of internal control over financial reporting,

c. Testing and evaluating whether a material weakness continues to exist, including using the work of others, and

d. Forming an opinion on whether a previously reported material weakness continues to exist.

20. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing whether a previously reported material weakness continues to exist involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section of the standard concurrently.

21. The engagement to report on whether a previously reported material weakness continues to exist 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.

22. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on whether a previously reported material weakness continues to exist.

23. 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 whether a previously reported material weakness continues to exist. 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. The auditor should assess materiality as of the date that management asserts that the previously reported material weakness no longer exists.

Planning the Engagement

24. The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise any assistants. When planning the engagement, 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

25. To perform this engagement, 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 in accordance with Auditing Standard No. 2 as of the date of the company's most recent annual assessment of internal control over financial reporting would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement.

> Note: The second sentence of the paragraph above 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 financial reporting as of the company's most recent year-end or more recently, then that auditor should follow the requirements for a successor auditor in paragraphs 26a-b and 27. 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 26 and 27 for a successor auditor.

26. When a successor auditor[3/] performs an engagement to report on whether a previously reported material weakness continues to exist and he or she has not yet completed an audit of internal control over financial reporting at the company, he or she must perform procedures to obtain sufficient knowledge of the company's business and its internal control over financial reporting to achieve the objective of the engagement, as described in paragraph 5 of this standard. 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 whether a previously reported material weakness continues to exist 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 addressing the material weakness.

[3/] 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*.

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. The auditor need not perform a walkthrough of major classes of transactions that are affected only indirectly by the controls specifically identified by management as addressing the material weakness.

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 address that material weakness.

27. A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 26 of this standard 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 whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Testing and Evaluating Whether a Material Weakness Continues to Exist

28. 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 no longer exists. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on whether a previously reported material weakness continues to exist, because one of the conditions for engagement completion described in paragraph 7 of this standard 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 management's evidence supporting management's assertion that a previously reported material weakness no longer exists.

29. 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 previously reported material weakness no longer exists 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.

30. 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 whether a previously reported material weakness continues to exist will 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.

31. All controls that are necessary to achieve the stated control objective(s) should, therefore, be specifically identified and evaluated. The specified controls will necessarily include controls that have been modified or newly implemented and also may include existing controls that previously were deemed effective during management's most recent annual assessment of internal control over financial reporting. 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 objective(s) if they operated as designed. In making this evaluation, the auditor should apply paragraphs 88 through 91 of Auditing Standard No. 2.

32. 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.

33. 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 whether a previously reported material weakness continues to exist. 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. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

34. The auditor should determine whether, based on the nature of the material weakness, 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. For example, a material weakness in the company's controls over the calculation of its bad debt reserve ordinarily would require that the auditor also perform substantive procedures to obtain sufficient evidence supporting an opinion about whether the material weakness continues to exist as of a specified date. In this circumstance, in addition to testing the design and operating effectiveness of the controls specifically identified as achieving the company's stated control objective that its bad debt reserve is reasonably estimated and recorded, the auditor ordinarily would need to perform substantive procedures to determine that, as of that same specified date, the company's bad debt reserve was fairly stated in relation to the company's financial statements taken as a whole.

35. 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.

Using the Work of Others

36. The auditor should evaluate whether to use the work performed by others in an engagement to report on whether a previously reported material weakness continues to exist. 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 otherwise would have performed, the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2.

37. The auditor's opinion relates to whether a material weakness no longer exists at the company because the stated control objective(s) is 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 that the control objectives related to each of the material weaknesses identified in management's assertion are achieved. 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 provide information about the effectiveness of internal control over financial reporting.

38. Paragraph 122 of Auditing Standard No. 2 should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. 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." There may, therefore, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

> Note: The requirement described in paragraph 26b of this standard for the auditor to perform a walkthrough applies only to an auditor who did not complete an audit of internal control over financial reporting as of the company's most recent annual assessment. An auditor who has rendered an opinion on the effectiveness of the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment is not required to perform a walkthrough as part of this engagement.

39. The following example illustrates how to apply this section on using the work of others to this engagement.

> 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.

Although certain 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 tests of controls that are centralized at the holding company level 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 no longer exists. 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 due to 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 supporting an opinion on the much narrower subject of whether a specified material weakness in internal control over financial reporting continues to exist, the examples in Auditing Standard No. 2 may not illustrate the appropriate application of using the work of others in this narrower engagement. For instance, 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. However, in most

cases, the auditor could not solely use the work of others for a control specified in management's assertion regarding a material weakness no longer existing 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 is applicable only in the context of a recurring engagement, which is not the context for the auditor's reporting on whether a previously reported material weakness continues to exist.

Opinions, Based in Part, on the Work of Another Auditor

40. 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 whether a previously reported material weakness continues to exist, with the following exception. If the auditor decides to serve as the principal auditor and to 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 Whether a Previously Reported Material Weakness Continues to Exist

41. When forming an opinion on whether a previously reported material weakness continues to exist, 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.

42. Management may conclude that a previously reported material weakness no longer exists because it has been reduced to a significant deficiency. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. Under paragraph 140 of Auditing Standard No. 2, a significant deficiency not corrected after some reasonable period of time is a strong indicator of a material weakness. Because the auditor is not required to provide an opinion under this voluntary engagement, the auditor could reasonably decline to provide an opinion under such circumstances.

43. The auditor may issue an opinion on whether a previously reported material weakness continues to exist only when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on whether a previously reported material weakness continues to exist, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement. A qualified opinion is not permitted.

Note: As described in paragraph 51 of this standard, the auditor's opinion on whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Therefore, the provisions of this standard do not distinguish between an unqualified opinion and an adverse opinion and, instead, refer simply to "an opinion" or "the auditor's opinion."

Requirement for Written Representations

44. In an engagement to report on whether a previously reported material weakness continues to exist, 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 management's 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 no longer exists 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 that has occurred or come to management’s attention since the date of management's most recent annual assessment of 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 indicate that the identified controls were not operating effectively as of, or subsequent to, the date specified in management's assertion.

45. The written representations should be signed by those members of management with overall responsibility for the company's internal control over financial reporting whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such

members of management ordinarily include the chief executive officer and chief financial officer or others with equivalent positions in the company.

46. 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 43 of this standard, if there is a limitation on the scope of an engagement to report on whether a previously reported material weakness continues to exist, 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.

Documentation Requirements

47. The documentation requirements in Auditing Standard No. 3, *Audit Documentation*, 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 29 of this standard, management's assertion that a material weakness no longer exists may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on whether a previously reported material weakness continues to exist may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on whether a previously reported material weakness continues to exist, 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 whether a previously reported material weakness continues to exist.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Management's Report

48. 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 of this standard. 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;

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 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 no longer exists as of the same specified date because the specified controls address the material weakness.

Auditor's Evaluation of Management's Report

49. 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.

50. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 48 of this standard, the conditions for engagement performance have not been met.

Auditor's Report

51. The auditor's report on whether a previously reported material weakness continues to exist must include the following elements:

a. A title that includes the word independent;

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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should refer to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness.

c. A description of the material weakness;

d. An identification of management's assertion that the identified material weakness in internal control over financial reporting no longer exists;

e. An identification of the management report that includes management's assertion, such as identifying the title of the report (if the report is titled);

f. A statement that management is responsible for its assertion;

g. An identification of the specific controls that management asserts address the material weakness;

> Note: As discussed further in paragraph 31, all controls that are necessary to achieve the stated control objective should be identified.

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 whether the material weakness continues to exist as of the date of management's assertion 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);

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 a previously reported material weakness continues to exist at the company;

l. A statement that the engagement includes examining evidence supporting management's assertion and performing such other procedures the auditor considered necessary in the circumstances and that the auditor obtained an understanding of internal control over financial reporting as part of his or her previous audit of management's annual assessment of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness;

> Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should include 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 exists (or no longer exists) 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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2 to read as follows: That the auditor has not 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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.

52. Example A-1 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists, expressed by an auditor who has previously reported on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent year-end (herein after referred to as a continuing auditor). Example A-2 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists expressed by a successor auditor.

53. As stated in paragraph 3 of this standard, the auditor may report on more than one previously reported material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 51 of this standard accordingly.

54. *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 56 of this standard.)

b. A significant subsequent event has occurred since the date being reported on. (See paragraphs 57 and 58 of this standard.)

c. Management's report on whether a material weakness continues to exist includes additional information. (See paragraphs 59 through 60 of this standard.)

55. As described further in paragraph 43 of this standard, the form of the auditor's report resulting from an engagement to report on whether a previously reported material weakness continues to exist may be an opinion on whether a material weakness continues to exist, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. 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 whether a material weakness continues to exist and, instead, withdraw from the engagement.

56. *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 whether any or all of the material weaknesses continue to exist. 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. When referring to his or her previously issued report on management's annual assessment, the auditor should either attach that report or include information about where it can be publicly obtained.

> Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording and references or attachments appropriately for use in a successor auditor's report.*]

Example A-3 in Appendix A is an illustrative report issued by a continuing auditor reporting on only one material weakness when additional material weaknesses previously were reported.

57. *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 44 of this standard, 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 relevant to the stated control objective or identified controls;
- Regulatory agency reports on the company's internal control over financial reporting relevant to the stated control objective or identified controls; and
- Information about the effectiveness of the company's internal control over financial reporting relevant to the stated control objective or identified controls obtained as a result of other engagements.

58. 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 61 regarding special considerations when a material weakness continues to exist. 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.

59. *Management's report includes additional information*. If management's report includes information in addition to the matters described in paragraph 48 of this standard, 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.

60. 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 59 outside its report on whether a previously reported material weakness continues to exist and includes them elsewhere within a document that contains management's and the auditor's reports on whether a previously reported material weakness continues to exist, the auditor would not need to disclaim an opinion, as described in paragraph 59. 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.

Special Considerations When a Previously Reported Material Weakness Continues to Exist

61. If the auditor determines that the previously reported material weakness continues to exist and the auditor reports on the results of the engagement, he or she must express an opinion that the material weakness exists as of the date specified by management.

62. As described in paragraph 55, the auditor is not required to issue a report as a result of this engagement. If the auditor does not issue a report in this circumstance, he or she must communicate, in writing, his or her conclusion that the material weakness continues to exist to the audit committee. Similarly, if the auditor identifies a material weakness during this engagement that has not been previously communicated to the audit committee in writing, the auditor must communicate that material weakness, in writing, to the audit committee.

63. Additionally, whenever the auditor concludes that a previously reported material weakness continues to exist, 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

64. For example, if the auditor were engaged to report on whether two separate material weaknesses continue to exist and concluded that one no longer exists and one continues to exist, the auditor's report could comprise either of the following: (1) a report that contained two opinions, one on the material weakness that the auditor concluded no longer exists and one opinion on the material weakness that the auditor concluded continues to exist, or (2) a report that contained only a single opinion on the material weakness that the auditor concluded no longer exists if the company modifies its assertion to address only the material weakness that the auditor concluded no longer exists. In the second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness continues to exist to the audit committee and also should apply paragraph 56 of this standard regarding other material weaknesses reported 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

Effective Date

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

Appendix A – Illustrative Reports on Whether a Previously Reported Material Weakness Continues to Exist

Paragraphs 51 through 60 of this standard provide direction on the auditor's report on whether a previously reported material weakness continues to exist. The following examples illustrate the application of those paragraphs.

Example A-1—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-2—*Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-3—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported*

Example A-1

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial

reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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 the effectiveness of specific controls or internal control over financial reporting overall 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*]

Example A-2

ILLUSTRATIVE AUDITOR'S REPORT FOR A SUCCESSOR AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

Report of Independent Registered Public Accounting Firm

We were engaged to report on whether a previously reported material weakness continues to exist at XYZ Company as of [*date of management's assertion*] and to audit management's next annual assessment of XYZ Company's internal control over financial reporting. Another auditor 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)."*]. The other auditor's report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. 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, the material weakness described above no longer exists 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 other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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*]

Example A-3

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION ON ONLY ONE PREVIOUSLY REPORTED MATERIAL WEAKNESS WHEN ADDITIONAL MATERIAL WEAKNESSES PREVIOUSLY WERE REPORTED

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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial

reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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. Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., 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 the effectiveness of specific controls or internal control over financial reporting overall 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*]

APPENDIX B

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents ***Paragraph***

Introduction

B1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and not accepting others.

Background

B2. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the Securities and Exchange Commission's (the "SEC" or "Commission") implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

B3. When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists.[1/] The federal securities laws provide part of that mechanism. Those laws require the company to disclose to investors any changes in internal control over financial reporting 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.[2/] Therefore, investors will learn of material improvements, such as the remediation of a material weakness, on a timely basis through quarterly disclosures.[3/]

B4. When a company determines that a material weakness has been remediated, it may determine that disclosure is sufficient. Some investors and companies, however, have called for the ability to bolster confidence in management's assertions about those

[1/] 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. The webcast of the November 18, 2004 SAG discussion and the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the Board's Web site at www.pcaobus.org.

[2/] See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

[3/] 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 materially during the year through these quarterly disclosures.

internal control improvements with the added assurance of the company's independent auditor.[4/]

B5. 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 provide requirements for general attest engagements; however, the Board determined that these standards lack sufficient specificity for this purpose.[5/] The Board, therefore, proposed an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

B6. The Board received 30 comment letters on its proposal, primarily from auditor and investor groups as well as from two issuers. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Voluntary Nature of Engagement

B7. The proposed standard explicitly stated that the engagement described by this standard is voluntary and that the standards of the PCAOB did not require an auditor to undertake this engagement when a material weakness was previously reported. In addition, the Board stressed the voluntary nature of this engagement at the public meeting proposing this standard.

[4/] The Standing Advisory Group's November 18, 2004 discussion included this type of encouragement.

[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 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 interim standards are available on the Board's Web site at www.pcaobus.org.

B8. The value and importance of the Board's standards providing the option of this type of auditor reporting on a material weakness was confirmed unanimously in the comment letters from investors and investor-related parties. Auditors were also supportive of the standard overall and its voluntary nature. Both of the issuers who commented indicated that they would be concerned if issuers become compelled to obtain such opinions. One of these commenters stressed that the disclosure requirements of management, coupled with enhanced criminal penalties, should provide investors with information regarding the continued existence or correction of a material weakness.

B9. The Board continues to believe that providing for this type of auditor reporting in its standards will serve the public interest. At the same time, the Board reaffirms that reporting on whether a material weakness continues to exist is a voluntary engagement and is not required by the standards of the PCAOB.

Form of the Auditor's Opinion

B10. The proposed standard called for the auditor to express a single opinion directly on the subject matter (i.e., the material weakness itself), rather than on management's assertion, as follows:

> 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*].

B11. Primarily auditors commented on the form of the opinion in the proposed standard and their comments reflected a wide spectrum of ideas. Some commenters expressed support for the auditor's report, including the form of the opinion as proposed. Other comments included a suggestion for two opinions, consistent with Auditing Standard No. 2—one on the subject matter (the elimination of the material weakness) and one on management's assertion. Other commenters suggested that just one opinion was sufficient, though these commenters were split regarding whether the one opinion should be on management's assertion or on the subject matter. Other commenters suggested that an opinion stating that the material weakness had been eliminated, without the phrase "because the stated control objective is met" would be a better alternative, while others asked the Board to consider an opinion stating that the identified controls were effective because the stated control objective was met, without stating that the material weakness had been eliminated.

B12. A number of commenters expressed concern with the phrasing "the material weakness has been eliminated," including the use of that phrase in the auditor's opinion and in the title of the proposed standard. These commenters believed that terminology such as "elimination" or "eliminated" might be too definite a term that might mislead report users into believing that there were no remaining deficiencies in the internal control over financial reporting in the area related to the specified material weakness, even though control deficiencies of a lesser severity than a material weakness might persist.

B13. After considering these suggestions, the Board decided to retain a single opinion on the subject matter and to revise the opinion wording. The Board continues to believe that a single opinion expressed directly on the subject matter is the simplest and clearest form of communication related to this engagement. Further, the Board believes that an auditor's opinion directly on the subject matter (i.e., the material weakness itself) will best achieve the overarching objective of this engagement—to clearly communicate as of an interim date auditor assurance about whether a previously reported material weakness continues to exist.

B14. The Board agreed with commenters that use of the term "elimination" might increase the risk that a report user would misunderstand the assurance provided by an auditor's opinion on a previously reported material weakness. As a result, the Board changed the form of the opinion to "In our opinion, the material weakness described above no longer exists as of [date of management's assertion]" and the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist." The text of the standard was modified throughout to delete references to "eliminated" or "elimination" and to reflect wording consistent with the revised opinion and title.

As-of Date of Report

B15. The proposed standard provided for significant flexibility by allowing the engagement to be undertaken at any time during the year, limited only by implications associated with the nature of the material weakness. In other words, the proposed standard did not require the engagement to be performed in conjunction with an audit or review of financial statements. Instead, the proposed standard required the auditor to determine whether management had selected an appropriate date for its assertion and specified several matters for the auditor to consider in making this determination.

B16. A number of auditors suggested that the engagement described by the proposed standard should be performed only as of quarterly financial reporting dates instead of as of any date during the year. These commenters believed that such a requirement would allow the auditor to integrate this work with the auditor's interim review procedures under AU sec. 722, *Interim Financial Information*, and provide a link between the auditor's report on the material weakness and management's quarterly disclosures of material changes in internal control. Commenters noted that many of the material weaknesses that have been disclosed to date are related to the period-end financial reporting process and that the auditor would therefore need to test controls in connection with a period-end to determine whether the material weakness continues to exist. Several commenters linked their suggestion that this engagement be performed only as of a quarterly financial reporting date to the view that the standard's direction on performing substantive procedures as part of this engagement should be bolstered (see separate discussion on performance of substantive procedures beginning at paragraph B51). One commenter pointed out, however, that if this engagement could be conducted only in connection with a quarterly financial reporting date, special guidance for applying the standard to foreign filers would be necessary because foreign filers are not required to report quarterly in the same manner as domestic filers.

B17. The Board believes that the flexibility provided in the proposed standard regarding the timing of the engagement is an important and appropriate feature of the standard. Although the Board agrees with commenters' observations that many of the material weaknesses disclosed during the past year were related to the period-end financial reporting process, the Board determined that the existing provisions of the proposed standard address this circumstance. In determining whether management has selected an appropriate date for its assessment, the standard requires the auditor to consider that controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

B18. Moreover, some material weaknesses—such as those that involve transaction-based controls that operate daily—are well suited for a management assertion and an auditor opinion that the material weakness no longer exists as of almost any date. Restricting an auditor's reporting on whether a material weakness continues to exist to only quarterly financial reporting dates could impose unnecessary delay on a company seeking auditor assurance that this type of material weakness no longer exists. For example, assume that a calendar year-end company had previously disclosed a material weakness that was the type that would lend itself well to reporting that it no longer existed as of any date. Further, management could not yet assert that the material weakness no longer existed as of March 31, but believed that it could make the assertion as of a date in April. If the standard restricted auditor reporting to a quarterly financial reporting date, the auditor would have to wait until June 30 to be able to attest to whether the material weakness continued to exist (and, presumably, would not be able to issue his or her report until July, at the earliest). While management could, in this example, provide timely disclosure to investors that the material weakness no longer existed, the Board concluded that structuring the provisions of the standard to potentially result in this kind of delay in auditor assurance would not serve the public interest.

B19. In light of these considerations, the Board decided to retain the provisions of the proposed standard that would permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B20. At least one auditor asked for clarification about whether a report issued pursuant to Auditing Standard No. 2 that identified a material weakness could be issued at the same time as a report pursuant to this standard indicating that the material weakness no longer exists as of a later date. The degree of flexibility regarding the timing of this engagement would permit the company (depending on the company's ability to assert that a material weakness no longer exists and the auditor's ability to timely audit that assertion) to simultaneously distribute its annual reports and the management assertion and auditor report described in this standard. Consistent with this flexible approach, nothing in this standard or Auditing Standard No. 2 would preclude the auditor from issuing a single, combined report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2 and the results of an engagement performed pursuant to this standard.

Applicability of the Standard to Material Weaknesses Not Previously Reported

B21. The proposed standard was structured to allow an auditor to report only on a previously reported material weakness. The proposed standard defined a previously reported material weakness as a material weakness that was previously described by an auditor's report issued pursuant to Auditing Standard No. 2. A material weakness initially identified *after* the company's annual assessment date could not, therefore, be the subject of an auditor's report under the proposed standard.

B22. Virtually all of the investors who submitted comment letters suggested that the standard should allow for auditor reporting on material weaknesses identified subsequent to the company's most recent annual assessment of internal control over financial reporting. Although some of these commenters expressed concern about the level of work that might be required of the auditor to thoroughly understand a material weakness not previously reported upon by an auditor, they did not believe that the standard should prohibit such reporting. One commenter stated that if a successor auditor could gain an understanding of a company's internal control sufficient to report on a material weakness that was identified and reported on by a predecessor auditor, an auditor should be able to gain the understanding necessary to report on a material weakness identified by management as of an interim date.

B23. The majority of the auditors who commented indicated strong opposition to allowing auditors to report in this engagement on material weaknesses not previously reported. These commenters suggested that the initial identification of a material weakness requires a level of understanding of the company's controls and the specific facts and circumstances surrounding the material weakness that can result only from a complete evaluation of the effectiveness of internal control over financial reporting. Additionally, at least one commenter expressed concern that the identification of a material weakness subsequent to the annual assessment is a strong indicator of a material change within the company's internal control over financial reporting. This commenter believed that in such a circumstance the auditor would not have sufficient knowledge of the current state of internal control over financial reporting to be able to consider the interaction and potential implications of the change on other controls. This commenter also believed that this situation would prevent the auditor, in most cases, from being able to determine whether the newly identified material weakness no longer exists.

B24. The Board decided to retain the approach described by the proposed standard. The Board believes that the issue of a newly identified material weakness being an indicator of a material change within a company's internal control over financial reporting is a valid concern. Although the change in internal control over financial reporting giving rise to any new material weakness may be confined specifically to the area in which the material weakness originally was identified, the change also could be more far-reaching. In such circumstances, the auditor may not be able to determine the effect of the change without performing a full audit of internal control over financial reporting.

B25. The Board also notes that there is an important distinction between material weaknesses previously identified in an auditor's report issued pursuant to Auditing Standard No. 2 and other newly identified material weaknesses. The primary purpose of the narrow engagement described by this standard is to establish a timely and reasonable mechanism that a company can use to remove any perceived "stain" upon its financial reporting due to an outstanding adverse audit opinion on internal control over financial reporting that identified a material weakness. In the case of a new material weakness that is identified and addressed by management as of an interim date, an adverse auditor opinion previously attesting to the material weakness would not exist and, therefore, the new material weakness would not be the subject of the same type of market focus.

B26. There is also a fundamental difference between the auditor reporting on a material weakness not previously reported and a successor auditor reporting on a material weakness that *was* reported in a predecessor auditor's opinion on internal control over financial reporting. The fundamental difference is the concept of material change described above. The successor auditor must obtain a sufficient understanding of the company's internal control over financial reporting to report on the existence of a material weakness that was previously reported. This successor auditor, however, has the benefit of knowing that the material weakness was identified in the context of an audit of the internal control over financial reporting as a whole and that the predecessor auditor should have adequately described the nature of the material weakness (particularly its pervasiveness and the extent of its effect on the company's financial reporting). In contrast, in situations in which a material change has taken place and a new material weakness has arisen after the previous annual assessment of internal control over financial reporting, neither the predecessor nor the successor auditor has obtained this level of understanding as it relates to the newly identified material weakness.

B27. These considerations, taken together, resulted in the Board's decision to retain the provisions of the proposed standard that limit this engagement only to material weaknesses that have been previously described in an auditor's report issued pursuant to Auditing Standard No. 2. The Board also made changes to the standard, as suggested by one commenter, to make these provisions clearer. These changes included changing the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" as well as conforming changes to the text of the standard to refer explicitly to a *previously reported* material weakness as the subject matter of this engagement.

Focus on Control Objectives

B28. The proposed standard focused on stated control objectives to determine whether a material weakness continues to exist and posited that if a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. Because the term "stated control objective" was not precisely defined elsewhere in the Board's auditing standards, the proposed standard provided a definition as well as examples of stated control objectives.

B29. A *stated control objective* in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. The stated control objective would provide management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist. For this reason, the proposed standard required that management and the auditor be satisfied that if the stated control objective were achieved the material weakness would no longer exist.

B30. Comments on the proposed standard's focus on control objectives came primarily from auditors. Many auditors, either explicitly or implicitly, supported the focus on control objectives. One auditor suggested that, given the importance of control objectives, the proposed standard should explicitly state that documentation of control objectives is required.

B31. Several auditors, however, expressed concerns about the proposed standard's focus on control objectives. A couple of these commenters suggested that the proposed standard's emphasis on control objectives might inappropriately establish a framework for evaluating the effectiveness of internal control over financial reporting that differs from, or otherwise adversely affects the proper application of, the Committee of Sponsoring Organizations of the Treadway Commission's publication *Internal Control – Integrated Framework* ("COSO").

B32. Most concerned commenters expressed apprehension that report users might be misled by an auditor's opinion that a material weakness had been eliminated because the control objectives had been met. They believed that this type of opinion might lead report users to mistakenly believe that if the control objectives were met, there were no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness—when, in fact, a significant deficiency or deficiency could continue to exist.

B33. Another commenter noted that the examples in the proposed standard illustrated only control objectives for the control activities component of internal control over financial reporting—not for the other components (control environment, risk assessment, monitoring, information and communication). This commenter suggested that examples of control objectives in the other components would be helpful. Another commenter suggested that, given the importance of the control objective concept, if the

Board's standards were to specifically address the concept, such a definition and discussion should reside in Auditing Standard No. 2. One concerned auditor concluded that, given the importance of control objectives, more guidance was needed, including clarification that if more than one control is necessary to achieve a stated control objective, all such controls must be identified and tested as part of this engagement.

B34. In response to comments, the Board decided to retain the definition of, and focus on, control objectives and provide additional guidance. The Board views the auditor's use of the concept of control objectives as analogous to the use of the concept of relevant assertions. The concept of relevant assertions was already familiar to experienced auditors and was specifically defined for the first time in Auditing Standard No. 2 because of that standard's focus on testing controls over all relevant assertions related to all significant accounts. Similarly, the concept of control objectives is familiar to most experienced auditors and is already used to describe the auditor's responsibilities under Auditing Standard No. 2).[6/] A definition of control objectives (and stated control objectives) is provided in this standard because of the standard's focus on control objectives as a specific measure for determining whether a material weakness continues to exist. This is consistent with the Board's objective for its standards to be clear as well as the focus on control objectives in the engagement described by this standard.

B35. The Board believes that the standard's focus on control objectives is sound and helpful and is an appropriate complement to the control criteria, such as COSO, for the purposes of this engagement. 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 to be applied to the facts and circumstances in a reasonable and appropriate manner. Accordingly, the emphasis in this standard on control objectives is consistent with, and supports a correct application of, COSO.

[6/] For example, paragraph 12 of Auditing Standard No. 2 states, "Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." Paragraph 85 of Auditing Standard No. 2 elaborates on this idea, including the example that, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. That paragraph concludes with the statement, "When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the [deficient] preventive control relates." Perhaps most notably, paragraph 88 of Auditing Standard No. 2 requires the auditor to identify the company's control objectives in each area and identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.

B36. The focus on whether the stated control objectives have been met as the target for determining whether a material weakness continues to exist does accommodate the circumstance in which a deficiency or significant deficiency continues to exist in that area of the company's internal control over financial reporting. Although several commenters linked this result with the focus on control objectives, this potential result would exist in any case within the overall construct of this standard, completely apart from the focus on control objectives. The potential for less severe deficiencies to persist in an area in which a previously reported material weakness no longer exists parallels the reporting results of an engagement performed under Auditing Standard No. 2. According to that standard, only material weaknesses (not less severe weaknesses) are disclosed in an auditor's report and only the existence of a material weakness and not less severe weaknesses affects the auditor's opinion on the effectiveness of the company's internal control over financial reporting. As an illustration, assume that a company that had previously reported a material weakness in internal control over financial reporting elected to wait until the auditor's next annual report issued pursuant to Auditing Standard No. 2 to obtain auditor assurance related to the existence of the material weakness. If the control weakness that had previously risen to the level of material weakness were reduced to a significant deficiency or deficiency as of the company's next year-end, the auditor's next report issued under Auditing Standard No. 2 would present an unqualified opinion indicating that the company's internal control over financial reporting was effective. The Board concluded that the users of an auditor's report on whether a previously reported material weakness continues to exist need only receive auditor assurance that the material weakness no longer exists and not more detailed information about whether less severe control deficiencies continue to persist.

B37. The Board notes, however, that paragraph 140 of Auditing Standard No. 2 states (in part) that strong indicators of a material weakness include circumstances in which significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. An auditor is not required to provide an opinion under this voluntary engagement, and could reasonably decline to provide an opinion under such circumstances.

B38. In response to comments that report users will mistakenly believe that an auditor's report issued pursuant to the standard's provisions is communicating auditor assurance that no control deficiencies exist in the area related to the former material weakness, the Board decided that the change in the title of the standard and the form of the auditor's opinion (discussed further in paragraph B14), coupled with this discussion, would sufficiently mitigate any potential for report users to misunderstand the assurance being provided by an engagement conducted under the this standard. Removing the concept of control objectives from the standard would not address the potential for misunderstanding because this potential exists independently of the focus on control objectives.

B39. With regard to the recommendation that the standard provide additional examples of stated control objectives, including stated control objectives related to components of internal control over financial reporting other than control activities, the Board determined that the provisions of the standard should remain largely at the conceptual level and state that the other components of internal control over financial reporting can be expressed in terms of control objectives. The Board also determined to emphasize, in the note to paragraph 17 of the standard, that when a material weakness has a pervasive effect on the company's internal control over financial reporting, it may be difficult to identify all of the relevant control objectives and the material weakness probably is not suitable for this type of narrow, interim reporting.

B40. For the purposes of this engagement, a stated control objective need not be more precise than to describe an objective that relates to whether there is a more than remote risk that the company's financial statements are materially misstated in a given area. For instance, paragraph 14 of the standard includes the example control objective, "The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example assumes that the product X inventory account related to the company's Dallas, TX warehouse represents a more than remote risk of material misstatement to the company's financial statements taken as a whole and has been identified as a separate significant account. This example does not suggest that a company should establish separate control objectives for all of its various types of inventory, by inventory location, regardless of materiality.

B41. Although the Board believes that the proposed standard made clear that in performing this engagement, the auditor should identify and test all controls necessary to achieve the stated control objective, based on the importance of this concept and in response to commenters, the Board concluded that an explicit clarification should be added. Not only must newly implemented or modified controls be identified and tested in this engagement, but *all* controls necessary to achieve the stated control objective must be identified and tested. For example, in a circumstance in which four controls must operate effectively for a given control objective to be achieved, the failure of one of those controls could result in a material weakness. In the context of this engagement, all four controls necessary to achieve the stated control objective would need to be specifically identified and tested. This must be the case because of the inherent limitations in internal control over financial reporting. If three of the four controls were found to be effective as of year-end, they cannot be assumed to be effective as of a later date. To render an opinion as of a current date about whether the material weakness exists, the auditor must have current evidence about whether all controls (in this example, all four controls) necessary to achieve the control objective are designed and operating effectively.

B42. Regarding the suggestion to include a requirement that control objectives be documented, the Board notes that neither COSO nor Auditing Standard No. 2 currently contain such a requirement. As with many aspects of assessing the effectiveness of internal control over financial reporting, the better the documentation, the easier and more efficient the evaluation, especially from the auditor's perspective. In the context of this engagement, by virtue of creating a stated control objective, the company and the auditor would document the stated control objective, even if that documentation appeared only in their respective reports. Therefore, documentation is effectively required for the stated control objectives encompassed by an engagement conducted under this standard. The Board does not believe, however, that establishing a broad requirement for documenting *all* control objectives related to a company's internal control over financial reporting is needed at this time or would be appropriately placed within this standard.

Concept of Materiality

B43. To provide direction on the concept of materiality, the proposed standard largely referred to Auditing Standard No. 2. The proposed standard stated that 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 whether a previously reported material weakness continues to exist. 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.

B44. Several auditors commented that the proposed standard should provide additional direction on how the auditor considers materiality in performing this engagement. Commenters believed that clarification was necessary regarding the appropriate time context for management's and the auditor's materiality judgments. These commenters asked whether materiality should be assessed as of the date management asserts to be the date at which the material weakness no longer exists, or as of the end of the prior year when the material weakness was originally reported.

B45. Most commenters on this issue suggested that the date for assessing materiality should be the date management asserts to be the date at which the material weakness no longer exists. Commenters noted, however, that this position would allow a material weakness to no longer exist merely as a result of a business acquisition or disposition, for example, because either of those actions would change materiality as of that point in time (and, in the case of a disposition, send the material weakness along with the disposed business).

B46. Several auditors suggested that the auditor's opinion should explicitly recognize the concept of materiality. Commenters suggested the following as alternatives that would recognize materiality: "Management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated, in all material respects . . ." and "XYZ Company has eliminated the material weakness with respect to the Company's internal control over financial reporting as described above as of [*date specified in management's assertion*], in all material respects." These commenters were concerned that the opinion described by the proposed standard misrepresented the precision of the auditor's assessment and neglected the notion of reasonable assurance.

B47. The Board decided that the provisions in the standard regarding materiality should be clarified to specify that materiality should be assessed as of the date management asserts that the material weakness no longer exists. The as-of date of management's assertion and the auditor's opinion is fundamental to the auditor's decisions about whether he or she has obtained sufficient evidence to support an opinion and to the auditor's evaluation of that evidence to form an opinion on whether the material weakness exists as of that point in time. The Board believes that the logical and internally consistent position regarding the time context for assessing materiality is to assess materiality as of the date that management asserts the material weakness no longer exists. The Board also believes that materiality can be assessed as of a date other than a financial reporting period-end. This is consistent with the Board's decision, discussed further beginning at paragraph B15, that the standard permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B48. The Board also believes that auditors should exercise caution in circumstances in which the only aspect of a previously reported material weakness that has changed is materiality (in other words, the size of the financial statement accounts has changed due to an acquisition or other activity rather than any changes in the design or operation of controls). In many such cases, the company will have undergone significant changes, with an associated change in internal control over financial reporting overall. In this circumstance, the auditor would need to perform procedures beyond the scope of work ordinarily contemplated under this standard to have a sufficient basis for his or her new assessment of materiality and an adequate understanding of the company's internal control over financial reporting overall. The Board believes that, in many cases in which the company has undergone a change of this magnitude, the auditor would need to perform a full audit of internal control over financial reporting in accordance with Auditing Standard No. 2 to have a sufficient basis for assessing materiality, understanding the company's internal control over financial reporting overall, and rendering an opinion about whether a material weakness continues to exist. Also, as discussed in paragraph B37, a previously reported material weakness may no longer exist because it has been reduced to a significant deficiency. In this circumstance, if management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness.

B49. Regarding the form of the auditor's opinion and concerns that the opinion suggested by the proposed standard implied an inappropriate degree of precision and neglected the concept of reasonable assurance, the Board concluded that the provisions of the proposed standard were sufficiently clear that the auditor's objective in this engagement was to plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist as of the date specified by management. Furthermore, the auditor's report described by the proposed standard included disclosure of this objective. The Board does not, therefore, believe that report users would mistakenly believe that the auditor's opinion, as proposed, would convey absolute assurance.

B50. In addition, the Board believes that including another reference to materiality in the auditor's opinion would not add anything of substance to the auditor's conclusion and could instead impair its readability. The determination of whether a material weakness exists is inherently linked to materiality. Stating that the material weakness no longer exists in all material respects would be redundant—the equivalent of saying that the financial statements are not materially misstated in all material respects. Accordingly, the Board has not added another reference to materiality in the auditor's opinion.

Performance of Substantive Procedures

B51. The proposed standard, consistent with its reliance on the existing provisions of Auditing Standard No. 2, focused largely on the tests of controls that the auditor must perform to obtain reasonable assurance that a material weakness no longer exists. The proposed standard additionally recognized that, in some cases, the auditor also would need to perform substantive procedures on account balances to obtain sufficient evidence as to whether a material weakness no longer exists.

B52. Several auditors believed that the proposed standard was too mild in its wording that the auditor "may determine" that performing substantive procedures was necessary. Those commenters believed that, to be consistent with the integrated audit concept of Auditing Standard No. 2 and to reflect the fact that identification of many material weaknesses during the past year occurred during the performance of substantive audit procedures, such wording did not adequately convey the importance of performing substantive procedures in an engagement to report on whether a previously reported material weakness continues to exist. Some commenters recommended that the standard set forth a presumptively mandatory requirement for the auditor to perform substantive audit procedures in all cases, while others suggested that strengthening the language or providing additional guidance about when substantive procedures are necessary would be sufficient.

B53. The Board continues to believe that in some circumstances, substantive procedures will not be necessary for the auditor to obtain sufficient evidence about whether a material weakness continues to exist. Like many aspects of this standard, the auditor's judgment in this area will depend on the nature of the material weakness. An auditor can obtain sufficient evidence to support an opinion on whether some material weaknesses continue to exist without the need for substantive procedures. Other material weaknesses necessitate substantive procedures for the auditor to obtain sufficient evidence. Therefore, the Board determined that it would be inappropriate to establish a presumptively mandatory requirement that substantive procedures be performed in all cases.

B54. The Board agreed, however, that the proposed standard did not sufficiently stress the potential importance of performing substantive procedures, depending on the nature of the material weakness. Paragraph 34 of the standard has, therefore, been modified in a manner that the Board believes better articulates the potential need to perform substantive procedures. An example also has been added to this paragraph of the standard to illustrate a circumstance in which substantive procedures ordinarily would need to be performed.

Using the Work of Others

B55. Similar to PCAOB Auditing Standard No. 2, the proposed standard permitted 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 applied the framework for using the work of others described in PCAOB Auditing Standard No. 2. That 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 persons performing the work.

B56. 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. 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. In contrast, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion as to whether a material weakness no longer exists would need to be applied at the control objective level.

B57. There were few comments on the provisions for using the work of others in this proposed standard. Most commenters who commented on these provisions expressed confusion about a passage in the example of proposed paragraph 36, which stated that "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." Commenters believed that walkthroughs were required in the proposed standard in all cases and that walkthroughs must be conducted by the auditor himself or herself.

B58. One auditor suggested clarifying within the proposed standard that the auditor will be able to use the work of others only in limited circumstances. This same commenter also believed that the bank reconciliation example presented in the proposed standard to illustrate how the auditor could use the work of others in this type of engagement was too simplistic and requested additional, more realistic examples.

B59. The Board continues to believe that the framework for using the work of others that was established in Auditing Standard No. 2 is appropriate for use in this context and, therefore, the provisions for using the work of others in the standard have been retained as proposed. At the same time, the Board determined that it would be helpful to clarify, through the following discussion, that the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on whether a material weakness continues to exist would need to be applied at the control objective level. A complete understanding of this feature of the standard is important because this provision allows for additional flexibility in the auditor's work.

B60. The auditor's opinion in this engagement is expressed only on whether the material weakness continues to exist—not on whether the individually identified controls are effective. As a result, the evaluation as to whether the auditor has obtained the principal evidence supporting his or her opinion should be made at the control objective level—not at the lower level of the controls individually identified in management's assertion and the auditor's report.

B61. If, for example, management's and the auditor's reports identify three separate previously reported material weaknesses that no longer exist, the auditor would, in effect, be rendering three separate opinions. Those opinions would indicate that each of the three individual material weaknesses continues to exist or no longer exists as of the date of management's assertion. The standard, therefore, would require the auditor to obtain the principal evidence that the *control objectives* related to each of the three identified material weaknesses were now achieved. However, the standard would not require that the auditor obtain the principal evidence that each *control specifically identified* in management's assertion as achieving the control objectives is effective.

B62. Auditing Standard No. 4 follows the same framework for using the work of others as Auditing Standard No. 2. There may, however, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The Board believes that no additional specific restriction on the use of the work of others is appropriate or necessary in the context of this engagement. Such a restriction would diminish the flexibility that the framework otherwise provides and perhaps inhibit the auditor's exercise of the judgment necessary to implement the framework appropriately. Furthermore, the Board does not believe that auditors need such direction within the standard to make appropriate decisions about using the work of others in this context.

B63. Similarly, the Board determined that no further examples of using the work of others were needed. The Board believes that additional examples demonstrating the application of the provisions in the standard for using the work of others to reflect more realistic (i.e., complex, fact-driven) situations is better handled outside of the standard itself and by auditors—in their audit methodology, training courses, and other venues.

B64. In response to confusion about the requirement for walkthroughs, the Board clarified the standard by adding a note to paragraph 38 and deleted the reference to a walkthrough from the example on using the work of others. Walkthroughs are required only of a successor auditor when the successor auditor performs this engagement before performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2. A continuing auditor that has opined already on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment and is engaged to conduct this narrow engagement is not required to perform any walkthroughs as part of this engagement.

Dividing Responsibility

B65. Due to the narrow scope of an engagement to report on whether a material weakness continues to exist, the provisions of the proposed standard allowed the principal auditor to use the work and reports of another auditor as a basis, in part, for his or her opinion. The proposed standard also prohibited the principal auditor from dividing responsibility for the engagement with another auditor.

B66. Very few comments were received on this provision of the proposed standard. One auditor suggested that, although dividing responsibility may not be appropriate in certain circumstances, the standard should not prohibit it. Another auditor expressed confusion about whether the principal auditor could refer to the report of the other auditor but not divide responsibility with the other auditor.

B67. The Board continues to believe that, based on the nature of the engagement described by the standard, the principal auditor should be prohibited from dividing responsibility for the engagement with another auditor. The Board's consideration of the nature of this engagement included recognition of the narrow scope of the work (i.e., whether a previously reported material weakness continues to exist), that the engagement would be voluntary, and that the assignment would be non-recurring (unlike the recurring nature of the audit of the financial statements or the audit of internal control over financial reporting). The Board notes that three appropriate alternatives exist in the circumstance in which another auditor is involved and the company wants to obtain auditor assurance that a previously reported material weakness no longer exists:

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by performing all of the testing required for this engagement himself or herself.

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by using the work and reports of another auditor as a basis, in part, for his or her opinion, and by taking responsibility for the work performed by the other auditor. In this case, the auditor may not make reference to the other auditor in his or her report on whether a previously reported material weakness continues to exist.

- The company could wait until year-end when the principal auditor would report on the effectiveness of internal control over financial reporting overall under the provisions of Auditing Standard No. 2.

B68. The Board concluded that the standard was sufficiently clear that the principal auditor could not divide responsibility with another auditor and, therefore, that the auditor also could not refer to the other auditor in his or her report. Accordingly, no change has been made to the standard in this regard.

New Material Weaknesses Identified

B69. The proposed standard was silent regarding the auditor's responsibilities if, during the performance of this engagement, he or she became aware of a new material weakness not previously reported on by an auditor.

B70. Several commenters requested that the standard address the auditor's responsibilities for new material weaknesses identified during this engagement and suggested what these responsibilities should be. One investor suggested that the standard should require the auditor to include disclosure of any new material weaknesses of which the auditor was aware in his or her report. This commenter stated that, otherwise, the auditor's report would become a way of telling investors the good news while concealing the bad news. Another commenter suggested that management should be required to include the new material weakness in management's assertion that would accompany the auditor's report and the auditor should then disclaim an opinion on the new material weakness.

B71. Both the identification of material weaknesses and the remediation of such weaknesses will be captured by management's voluntary and required reporting under the SEC's rules. Accordingly, the provisions of this standard do not facilitate management's ability to conceal from investors the emergence of a new material weakness at the company. Nevertheless, the Board agreed that when an auditor identifies a new material weakness during the performance of this engagement, the auditor should not simply remain silent. Accordingly, the Board modified the standard to require the auditor to communicate, in writing, to the audit committee any material weaknesses identified during this engagement that the auditor had not previously communicated, in writing, to the audit committee.

B72. The existing provisions of Auditing Standard No. 2 contain responsibilities for the auditor if (1) information comes to the auditor's attention during this engagement that leads him or her to believe, while performing quarterly procedures required by Auditing Standard No. 2, that management's quarterly disclosures are materially misleading, or

(2) the auditor becomes aware of conditions that existed at the date of his or her last report issued under Auditing Standard No. 2.

B73. Paragraphs 202-206 of Auditing Standard No. 2 establish certain requirements for the auditor related to management's quarterly and annual certifications with respect to the company's internal control over financial reporting. If matters come to the auditor's attention during this engagement that lead him or her to believe, while fulfilling these quarterly requirements, that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and the SEC's rules, these provisions of Auditing Standard No. 2 require the auditor to take action. Such actions escalate from auditor communications with management and then to the audit committee, culminating in the auditor considering his or her additional responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

B74. In addition, a continuing or predecessor auditor would have responsibilities under paragraph 197 of Auditing Standard No. 2 if the existence of a new material weakness came to the auditor's attention. This paragraph effectively extends the responsibilities in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, to reports on the effectiveness of internal control over financial reporting issued pursuant to Auditing Standard No. 2. The identification of a new material weakness in the current year would cause the auditor, in fulfilling these responsibilities, to determine whether the facts relating to the material weakness existed at the date of the auditor's report pursuant to Auditing Standard No. 2 and, if so, (1) whether those facts would have changed the auditor's report issued under Auditing Standard No. 2 if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. If the auditor determined that the new material weakness identified in the current year actually existed as of the date of his or her previous report under Auditing Standard No. 2 and that it was not adequately identified and disclosed in that report, the auditor would need to take steps such as recalling and reissuing the previous report to ensure that investors did not continue to rely on the previously issued (erroneous) report.

B75. Including newly identified material weaknesses in the auditor's report could potentially mislead investors into believing that the assurance provided by this type of engagement is broader than it actually is. If report users were provided with disclosure (covered by the auditor's opinion) of new material weaknesses of which the auditor was aware, report users might incorrectly believe that the auditor's report captured *all* new material weaknesses that had arisen at the company. Similarly, a requirement for the auditor to disclose any new material weaknesses could lead report users to conclude, incorrectly, that no such disclosure means that there is current auditor assurance over the whole of internal control over financial reporting at the company. The objective of this engagement is to provide auditor assurance about whether a previously reported material weakness continues to exist—nothing broader. The only way for investors to obtain a more complete report from the auditor would be for the auditor to audit internal control over financial reporting in accordance with Auditing Standard No. 2.

Specific Identification of All Previously Reported Material Weaknesses

B76. The proposed standard required the auditor to modify his or her report if the auditor provides assurance on less than all of the material weaknesses previously reported. The proposed standard did not, however, require the auditor to specifically identify all of the previously reported material weaknesses not covered.

B77. All investors who commented on this issue suggested that all material weaknesses previously reported either should be referred to or specifically included in the auditor's report. They indicated that failure to identify the additional material weaknesses might lead some users to erroneously conclude that they no longer exist. Auditors, on the other hand, agreed that complete specific identification of the previously reported material weaknesses not covered by the auditor's opinion should not be included, primarily because they believe that it may increase the risk of confusion about the scope of the engagement and what is being covered in the auditor's opinion. Several commenters who agreed that specific identification was not necessary suggested that in addition to the report modification included in the proposed standard, the auditor's report on this engagement should specifically direct the reader to the previous auditor's report (issued under Auditing Standard No. 2), by either attaching a copy of the audit report or by providing direction as to where the report could be obtained.

B78. The Board believes that including a complete specific identification of the previously reported material weaknesses not covered by this engagement would prove problematic. As noted by many commenters, it is possible that including this detail would confuse report readers regarding the scope of this narrow engagement and could imply that, unless told otherwise, a report user should assume that those other material weaknesses *do* continue to exist. In some of the material weakness descriptions included in management's and the auditor's reports on the effectiveness of the company's internal control over financial reporting as of year-end, the description of multiple material weaknesses covered several pages. That level of detail in an auditor's report specifically targeted at whether just one material weakness continues to exist could easily overwhelm the rest of the audit report, making the report prone to various kinds of misinterpretations.

B79. The Board concluded that report readers would be better served by requiring the auditor to provide information regarding where to obtain the previously issued audit report—either by attaching it or referring to where it could be publicly obtained.

Other Reporting Matters

B80. *No Requirement to Issue a Report*. The proposed standard required that the auditor, if he or she concluded that the material weakness continues to exist, communicate that conclusion in writing to the audit committee. The proposed standard, however, did not require the issuance of a report. Rather, the proposed standard recognized that the auditor must consider this knowledge in connection with the auditor's responsibilities under Auditing Standard No. 2 to determine whether management's quarterly disclosures about internal control over financial reporting are not materially misleading.

B81. Several auditors who commented recommended that the proposed standard should require the auditor to issue an adverse report in the event that the auditor concludes that the material weakness continues to exist. One suggested that issuance of an adverse report would be necessary only if the auditor believed that the company had previously publicly disclosed that the material weakness had been addressed.

B82. The Board continues to believe that requiring the issuance of an adverse report to the company would serve no useful purpose in this circumstance because the company might not make such a report public. The Board believes, therefore, that requiring the auditor to communicate, in writing, with the audit committee his or her conclusion that a material weakness that was the subject of this engagement continues to exist would serve the same purpose as requiring the issuance of an adverse report. At the same time, such a requirement would provide the auditor with additional flexibility as to the form of communication that would be most meaningful to the audit committee. Regarding the potential for management to lead investors to incorrectly believe that the material weakness no longer exists in its public disclosures, the Board believes that the federal securities laws, as well as auditor's existing responsibilities related to management's quarterly disclosures, are adequate safeguards to protect investors from misleading information.

B83. *No Distinction in Standard Between Unqualified and Adverse Opinion*. As discussed in the note to paragraph 43 of the standard, the standard no longer distinguishes between an unqualified and an adverse opinion. The auditor's opinion was revised to state that the material weakness exists or no longer exists. This revision is discussed further in the section "Form of Auditor's Opinion" and is now referred to in the standard as the auditor's opinion.

B84. *Inherent Limitations*. The inherent limitations paragraph of the auditor's report provided in the proposed standard discussed the inherent limitations of internal control over financial reporting overall, rather than the inherent limitations of the controls related to the material weakness being reported on.

B85. One commenter suggested that the inherent limitations paragraph was too broad for this engagement and needed to be modified to more accurately reflect the narrow focus of this type of engagement.

B86. The Board agreed that the inherent limitations paragraph, in this context, should be targeted to the specific controls identified in this auditor report. In addition, the Board continues to believe that the broader concept of inherent limitations in internal control over financial reporting overall is equally applicable. The inherent limitations paragraph in the auditor's report has been modified to reflect both of these conclusions.

B87. *Obtaining an Understanding of Internal Control Over Financial Reporting.* The proposed standard included a required report element stating 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." This language also was included in the example report included in the proposed standard.

B88. Several auditors expressed concern that the phrase, "the engagement includes obtaining an understanding of internal control over financial reporting," implies that, as a part of the current engagement, the auditor spent a significant amount of time understanding internal control over financial reporting overall rather than carrying forward his or her understanding from the prior annual audit. These commenters believed this implication conflicted with the direction in the body of the proposed standard that 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 this engagement. One commenter acknowledged that the proposed wording may be appropriate in cases in which a successor auditor is performing this engagement without previously gaining that understanding.

B89. The Board continues to believe that an auditor who has audited the company's internal control over financial reporting as of the company's most recent annual assessment 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 whether a previously reported material weakness continues to exist. To require a continuing auditor to update and document his or her understanding of internal control over financial reporting overall (to the full measure required by Auditing Standard No. 2) would be unnecessarily burdensome and costly. The Board modified the report element for a continuing auditor to clarify that the auditor previously obtained an understanding of internal control over financial reporting overall at the company and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness.

B90. The Board continues to believe, however, that a successor auditor that has not yet audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 would need to obtain a current understanding of internal control over financial reporting in connection with this engagement. Therefore, the report element described in the proposed standard is appropriate and has been retained for a successor auditor's reporting.

B91. *Example Reports*. The proposed standard included only one example report, which illustrated reporting on one material weakness by a continuing auditor when no additional material weaknesses were reported previously. Several commenters requested modification of the standard to address circumstances that the Board believed were already addressed by the proposed standard but were not illustrated in the single example report. Some commenters also made specific requests for additional example reports.

B92. The Board determined, after considering the nature of the comments, that additional example reports, while not covering all possible situations, would provide additional clarity to the various reporting situations. The Board selected three reports to illustrate most facets of the reporting provisions of the standard. Appendix A includes those reports.

Conforming Amendments to AT sec. 101

B93. The proposed standard contained a proposed conforming amendment to AT sec. 101, *Attest Engagements*. The proposed conforming amendment would have required the proposed standard to be used, rather than AT sec. 101, for any engagements in which the subject matter is whether a material weakness continues to exist. This conforming amendment would have precluded the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement was whether a material weakness continues to exist.

B94. The Board received few comments related to the proposed conforming amendment. One auditor agreed that a conforming amendment to preclude a review-level attestation was appropriate when the subject matter was whether a material weakness continues to exist. This commenter went on to suggest, however, that there could be appropriate uses for an agreed-upon procedures engagement and that the Board should not preclude agreed-upon procedures from being performed under the Board's standards. Such reports, the commenter noted, would be restricted to the use of the specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes and, therefore, these reports would not generally be available to investors. Thus, these reports would not be a substitute for the engagements addressed in the proposed standard. Another commenter separately suggested broadly retaining the ability for the auditor to perform a review engagement when the subject matter is a previously reported material weakness.

B95. The Board continues to believe that investors and other report users in the public domain will be best served by the Board's standards permitting only positive assurance (i.e., an examination-level attestation) from the auditor when the subject matter is whether a material weakness continues to exist. The Board agrees, however, that private parties (such as audit committees) who wish to engage the auditor to perform specified procedures when the subject matter is whether a material weakness continues to exist should be allowed to negotiate such a private arrangement, as long as the results are not intended for public use. The Board, therefore, decided to modify the conforming amendment to AT sec. 101 of the Board's interim standards. As adopted, an auditor may not use AT 101 to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use.

***Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* – Reporting on Whether a Previously Reported Material Weakness Continues to Exist**

Attestation Standards

AT sec. 101, Attest Engagements

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

Engagements in which the practitioner is engaged to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist.*

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-   ; File No. PCAOB-2004-014)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No 4, "Reporting on Whether a Material Weakness Continues to Exist."

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on July 28, 2005, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rule described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rule.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On July 26, 2005, the Board adopted Auditing Standard No. 4, "Reporting on Whether a Material Weakness Continues to Exist." The proposed rule text is set out below.

Auditing Standard No. 4 –

REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST

Table of Contents

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard – *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Applicability of Standard

1. This standard establishes requirements and provides direction that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting (hereinafter referred to as a material weakness) continues to exist as of a date specified by management.

> Note 1: In this context, *previously reported material weakness* means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 2**,** *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

> Note 2: The date specified by management as the date that the previously reported material weakness no longer exists must be a date after the date of management's most recent annual assessment.

2. An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist 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*, as of the date of the company's most recent annual assessment of internal control over financial reporting, 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 26 of this standard for additional requirements that apply specifically to a successor auditor's application of this standard.)

> Note: References in this standard to the company's most recent annual assessment of internal control over financial reporting apply to the company's most recent assessment of internal control over financial reporting overall, either as of the company's year-end or as of a more recent interim date, as audited by the auditor in accordance with Auditing Standard No. 2.

3. The auditor may report on more than one previously reported material weakness as part of a single engagement.

4. 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 whether a previously reported material weakness continues to exist. 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.

Auditor's Objective in an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

5. The auditor's objective in an engagement to report on whether a previously reported material weakness continues to exist is to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon. The auditor's opinion relates to the existence 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.

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 a material weakness continues to exist.

Conditions for Engagement Performance

7. The auditor may report on whether a previously reported material weakness continues to exist at a company only if all of the following conditions are 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 addresses the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and management's stated control objective(s);

c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

d. Management supports its assertion with sufficient evidence, including documentation; and

e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 48 of this standard.

8. If all the conditions in paragraph 7 of this standard are not met, the auditor is not permitted to complete the engagement to report on whether a previously reported material weakness continues to exist.

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 whether a previously reported material weakness continues to exist, both management and the auditor must use both (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 continues to exist.

> 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.*)

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 states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement to or omission in that relevant assertion is prevented or detected by controls on a timely basis.[1/]

12. 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,

[1/] See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

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.

13. In an audit of internal control over financial reporting, the auditor is required to identify the company's control objectives in each area and to identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.[2/]

14. 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

15. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved.

16. A *stated control objective* in the context of an engagement to report on whether a material weakness continues to exist is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing.

[2/] See paragraph 88 of Auditing Standard No. 2.

17. Because the stated control objective, for purposes of this engagement, provides management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

> Note: When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the related control objectives that are not being achieved may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment would be an example of this circumstance. If management and the auditor have difficulty identifying *all* of the stated control objectives affected by a material weakness, the material weakness probably is not suitable for this engagement and should be addressed, instead, through the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

Performing an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

18. In an engagement to report on whether a previously reported material weakness continues to exist, 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 1: 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.

> Note 2: 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, the auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Applying the Standards of the PCAOB

19. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on whether a previously reported material weakness continues to exist. Adherence to the standards involves:

a. Planning the engagement,

b. Obtaining an understanding of internal control over financial reporting,

c. Testing and evaluating whether a material weakness continues to exist, including using the work of others, and

d. Forming an opinion on whether a previously reported material weakness continues to exist.

20. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing whether a previously reported material weakness continues to exist involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section of the standard concurrently.

21. The engagement to report on whether a previously reported material weakness continues to exist 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.

22. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on whether a previously reported material weakness continues to exist.

23. 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 whether a previously reported material weakness continues to exist. 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. The auditor should assess materiality as of the date that management asserts that the previously reported material weakness no longer exists.

Planning the Engagement

24. The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise any assistants. When planning the engagement, 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

25. To perform this engagement, 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 in accordance with Auditing Standard No. 2 as of the date of the company's most recent annual assessment of internal control over financial reporting would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement.

> Note: The second sentence of the paragraph above 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 financial reporting as of the company's most recent year-end or more recently, then that auditor should follow the requirements for a successor auditor in paragraphs 26a-b and 27. 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 26 and 27 for a successor auditor.

26. When a successor auditor[3/] performs an engagement to report on whether a previously reported material weakness continues to exist and he or she has not yet completed an audit of internal control over financial reporting at the company, he or she must perform procedures to obtain sufficient knowledge of the company's business and its internal control over financial reporting to achieve the objective of the engagement, as described in paragraph 5 of this standard. 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 whether a previously reported material weakness continues to exist 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

[3/] 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*.

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 addressing the material weakness.

> 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. The auditor need not perform a walkthrough of major classes of transactions that are affected only indirectly by the controls specifically identified by management as addressing the material weakness.

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 address that material weakness.

27. A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 26 of this standard 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 whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Testing and Evaluating Whether a Material Weakness Continues to Exist

28. 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 no longer exists. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on whether a previously reported material weakness

continues to exist, because one of the conditions for engagement completion described in paragraph 7 of this standard 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 management's evidence supporting management's assertion that a previously reported material weakness no longer exists.

29. 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 previously reported material weakness no longer exists 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.

30. 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 whether a previously reported material weakness continues to exist will 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.

31. All controls that are necessary to achieve the stated control objective(s) should, therefore, be specifically identified and evaluated. The specified controls will

necessarily include controls that have been modified or newly implemented and also may include existing controls that previously were deemed effective during management's most recent annual assessment of internal control over financial reporting. 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 objective(s) if they operated as designed. In making this evaluation, the auditor should apply paragraphs 88 through 91 of Auditing Standard No. 2.

32. 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.

33. 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 whether a previously reported material weakness continues to exist. 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. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

34. The auditor should determine whether, based on the nature of the material weakness, 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. For example, a material weakness in the company's controls over the calculation of its bad debt reserve ordinarily would require that the auditor also perform substantive procedures to obtain sufficient evidence supporting an opinion about whether the material weakness continues to exist as of a specified date. In this circumstance, in addition to testing the design and operating effectiveness of the controls specifically

identified as achieving the company's stated control objective that its bad debt reserve is reasonably estimated and recorded, the auditor ordinarily would need to perform substantive procedures to determine that, as of that same specified date, the company's bad debt reserve was fairly stated in relation to the company's financial statements taken as a whole.

35. 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.

Using the Work of Others

36. The auditor should evaluate whether to use the work performed by others in an engagement to report on whether a previously reported material weakness continues to exist. 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 otherwise would have performed, the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2.

37. The auditor's opinion relates to whether a material weakness no longer exists at the company because the stated control objective(s) is 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 that the control objectives related to each of the material weaknesses identified in management's assertion are achieved. 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 provide information about the effectiveness of internal control over financial reporting.

38. Paragraph 122 of Auditing Standard No. 2 should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. 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." There may, therefore, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

> Note: The requirement described in paragraph 26b of this standard for the auditor to perform a walkthrough applies only to an auditor who did not complete an audit of internal control over financial reporting as of the company's most

recent annual assessment. An auditor who has rendered an opinion on the effectiveness of the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment is not required to perform a walkthrough as part of this engagement.

39. The following example illustrates how to apply this section on using the work of others to this engagement.

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.

Although certain 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 tests of controls that are centralized at the holding company level 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 no longer exists. 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 due to 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 supporting an opinion on the much narrower subject of whether a specified material weakness in internal control over financial reporting continues to exist, the examples in Auditing Standard No. 2 may not illustrate the appropriate application of using the work of others in this narrower engagement. For instance, 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. However, in most cases, the auditor could not solely use the work of others for a control specified in management's assertion regarding a material weakness no longer existing 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 is applicable only in the context of a recurring engagement, which is not the context for the auditor's reporting on whether a previously reported material weakness continues to exist.

Opinions, Based in Part, on the Work of Another Auditor

40. 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 whether a previously reported material weakness continues to exist, with the following exception. If the auditor decides to serve as the principal auditor and to 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 Whether a Previously Reported Material Weakness Continues to Exist

41. When forming an opinion on whether a previously reported material weakness continues to exist, 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.

42. Management may conclude that a previously reported material weakness no longer exists because it has been reduced to a significant deficiency. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. Under paragraph 140 of Auditing Standard No. 2, a significant deficiency not corrected after some reasonable period of time is a strong indicator of a material weakness. Because the auditor is not

required to provide an opinion under this voluntary engagement, the auditor could reasonably decline to provide an opinion under such circumstances.

43. The auditor may issue an opinion on whether a previously reported material weakness continues to exist only when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on whether a previously reported material weakness continues to exist, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement. A qualified opinion is not permitted.

> Note: As described in paragraph 51 of this standard, the auditor's opinion on whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Therefore, the provisions of this standard do not distinguish between an unqualified opinion and an adverse opinion and, instead, refer simply to "an opinion" or "the auditor's opinion."

Requirement for Written Representations

44. In an engagement to report on whether a previously reported material weakness continues to exist, 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 management's 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 no longer exists 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 that has occurred or come to management's attention since the date of management's most recent annual assessment of 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 indicate that the identified controls were not operating effectively as of, or subsequent to, the date specified in management's assertion.

45. The written representations should be signed by those members of management with overall responsibility for the company's internal control over financial reporting whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management ordinarily include the chief executive officer and chief financial officer or others with equivalent positions in the company.

46. 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 43 of this standard, if there is a limitation on the scope of an engagement to report on whether a previously reported material weakness continues to exist, 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.

Documentation Requirements

47. The documentation requirements in Auditing Standard No. 3, *Audit Documentation*, 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 29 of this standard, management's assertion that a material weakness no longer exists may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on whether a previously reported material weakness continues to exist may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on whether a previously reported material weakness continues to exist, 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 whether a previously reported material weakness continues to exist.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Management's Report

48. 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 of this standard. 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;

> 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 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 no longer exists as of the same specified date because the specified controls address the material weakness.

Auditor's Evaluation of Management's Report

49. 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.

50. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 48 of this standard, the conditions for engagement performance have not been met.

Auditor's Report

51. The auditor's report on whether a previously reported material weakness continues to exist must include the following elements:

a. A title that includes the word independent;

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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should refer to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness.

c. A description of the material weakness;

d. An identification of management's assertion that the identified material weakness in internal control over financial reporting no longer exists;

e. An identification of the management report that includes management's assertion, such as identifying the title of the report (if the report is titled);

f. A statement that management is responsible for its assertion;

g. An identification of the specific controls that management asserts address the material weakness;

> Note: As discussed further in paragraph 31, all controls that are necessary to achieve the stated control objective should be identified.

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 whether the material weakness continues to exist as of the date of management's assertion 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);

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 a previously reported material weakness continues to exist at the company;

l. A statement that the engagement includes examining evidence supporting management's assertion and performing such other procedures the auditor considered necessary in the circumstances and that the auditor obtained an understanding of internal control over financial reporting as part of his or her previous audit of management's annual assessment of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness;

> Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should include 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 exists (or no longer exists) 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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2 to read as follows: That the auditor has not 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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.

52. Example A-1 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists, expressed by an auditor who has previously

reported on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent year-end (herein after referred to as a continuing auditor). Example A-2 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists expressed by a successor auditor.

53. As stated in paragraph 3 of this standard, the auditor may report on more than one previously reported material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 51 of this standard accordingly.

54. *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 56 of this standard.)

b. A significant subsequent event has occurred since the date being reported on. (See paragraphs 57 and 58 of this standard.)

c. Management's report on whether a material weakness continues to exist includes additional information. (See paragraphs 59 through 60 of this standard.)

55. As described further in paragraph 43 of this standard, the form of the auditor's report resulting from an engagement to report on whether a previously reported material weakness continues to exist may be an opinion on whether a material weakness continues to exist, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. 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 whether a material weakness continues to exist and, instead, withdraw from the engagement.

56. *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 whether any or all of the material weaknesses continue to exist. 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. When referring to his or her previously issued report on management's annual assessment, the auditor should either attach that report or include information about where it can be publicly obtained.

> Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording and references or attachments appropriately for use in a successor auditor's report.*]

Example A-3 in Appendix A is an illustrative report issued by a continuing auditor reporting on only one material weakness when additional material weaknesses previously were reported.

57. *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 44 of this standard, 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 relevant to the stated control objective or identified controls;

- Regulatory agency reports on the company's internal control over financial reporting relevant to the stated control objective or identified controls; and

- Information about the effectiveness of the company's internal control over financial reporting relevant to the stated control objective or identified controls obtained as a result of other engagements.

58. 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 61 regarding special considerations when a material weakness continues to exist. 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.

59. *Management's report includes additional information*. If management's report includes information in addition to the matters described in paragraph 48 of this standard, 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.

60. 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 59 outside its report on whether a previously reported material weakness continues to exist and includes them elsewhere within a document that contains management's and the auditor's reports on whether a previously reported material weakness continues to exist, the auditor would not need to disclaim an opinion, as described in paragraph 59. 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.

Special Considerations When a Previously Reported Material Weakness Continues to Exist

61. If the auditor determines that the previously reported material weakness continues to exist and the auditor reports on the results of the engagement, he or she must express an opinion that the material weakness exists as of the date specified by management.

62. As described in paragraph 55, the auditor is not required to issue a report as a result of this engagement. If the auditor does not issue a report in this circumstance, he or she must communicate, in writing, his or her conclusion that the material weakness continues to exist to the audit committee. Similarly, if the auditor identifies a material weakness during this engagement that has not been previously communicated to the audit committee in writing, the auditor must communicate that material weakness, in writing, to the audit committee.

63. Additionally, whenever the auditor concludes that a previously reported material weakness continues to exist, 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

64. For example, if the auditor were engaged to report on whether two separate material weaknesses continue to exist and concluded that one no longer exists and one continues to exist, the auditor's report could comprise either of the following: (1) a report that contained two opinions, one on the material weakness that the auditor concluded no longer exists and one opinion on the material weakness that the auditor concluded continues to exist, or (2) a report that contained only a single opinion on the material weakness that the auditor concluded no longer exists if the company modifies its assertion to address only the material weakness that the auditor concluded no longer exists. In the second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness continues to exist to the audit committee and also should apply paragraph 56 of this standard regarding other material weaknesses reported 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

Effective Date

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

Appendix A – Illustrative Reports on Whether a Previously Reported Material Weakness Continues to Exist

Paragraphs 51 through 60 of this standard provide direction on the auditor's report on whether a previously reported material weakness continues to exist. The following examples illustrate the application of those paragraphs.

Example A-1—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-2—*Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-3—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported*

Example A-1

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

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,* f*or 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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial

reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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 the effectiveness of specific controls or internal control over financial reporting overall 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*]

Example A-2

ILLUSTRATIVE AUDITOR'S REPORT FOR A SUCCESSOR AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

Report of Independent Registered Public Accounting Firm

We were engaged to report on whether a previously reported material weakness continues to exist at XYZ Company as of [*date of management's assertion*] and to audit management's next annual assessment of XYZ Company's internal control over financial reporting. Another auditor 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,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. The other auditor's report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. 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, the material weakness described above no longer exists 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 other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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*]

Example A-3

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION ON ONLY ONE PREVIOUSLY REPORTED MATERIAL WEAKNESS WHEN ADDITIONAL MATERIAL WEAKNESSES PREVIOUSLY WERE REPORTED

<u>Report of Independent Registered Public Accounting Firm</u>

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,* f*or 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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial

reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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. Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., 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 the effectiveness of specific controls or internal control over financial reporting overall 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*]

APPENDIX B

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents	***Paragraph***

Introduction

B1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and not accepting others.

Background

B2. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the Securities and Exchange Commission's (the "SEC" or "Commission") implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

B3. When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists.[1/] The federal securities laws provide part of that mechanism. Those laws require the company to disclose to investors any changes in internal control over financial reporting 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.[2/] Therefore, investors will learn of material improvements, such as the remediation of a material weakness, on a timely basis through quarterly disclosures.[3/]

B4. When a company determines that a material weakness has been remediated, it may determine that disclosure is sufficient. Some investors and companies, however, have called for the ability to bolster confidence in management's assertions about those

[1/] 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. The webcast of the November 18, 2004 SAG discussion and the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the Board's Web site at www.pcaobus.org.

[2/] See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

[3/] 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 materially during the year through these quarterly disclosures.

internal control improvements with the added assurance of the company's independent auditor.[4/]

B5. 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 provide requirements for general attest engagements; however, the Board determined that these standards lack sufficient specificity for this purpose.[5/] The Board, therefore, proposed an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

B6. The Board received 30 comment letters on its proposal, primarily from auditor and investor groups as well as from two issuers. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Voluntary Nature of Engagement

B7. The proposed standard explicitly stated that the engagement described by this standard is voluntary and that the standards of the PCAOB did not require an auditor to undertake this engagement when a material weakness was previously reported. In addition, the Board stressed the voluntary nature of this engagement at the public meeting proposing this standard.

[4/] The Standing Advisory Group's November 18, 2004 discussion included this type of encouragement.

[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 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 interim standards are available on the Board's Web site at www.pcaobus.org.

B8. The value and importance of the Board's standards providing the option of this type of auditor reporting on a material weakness was confirmed unanimously in the comment letters from investors and investor-related parties. Auditors were also supportive of the standard overall and its voluntary nature. Both of the issuers who commented indicated that they would be concerned if issuers become compelled to obtain such opinions. One of these commenters stressed that the disclosure requirements of management, coupled with enhanced criminal penalties, should provide investors with information regarding the continued existence or correction of a material weakness.

B9. The Board continues to believe that providing for this type of auditor reporting in its standards will serve the public interest. At the same time, the Board reaffirms that reporting on whether a material weakness continues to exist is a voluntary engagement and is not required by the standards of the PCAOB.

Form of the Auditor's Opinion

B10. The proposed standard called for the auditor to express a single opinion directly on the subject matter (i.e., the material weakness itself), rather than on management's assertion, as follows:

> 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*].

B11. Primarily auditors commented on the form of the opinion in the proposed standard and their comments reflected a wide spectrum of ideas. Some commenters expressed support for the auditor's report, including the form of the opinion as proposed. Other comments included a suggestion for two opinions, consistent with Auditing Standard No. 2—one on the subject matter (the elimination of the material weakness) and one on management's assertion. Other commenters suggested that just one opinion was sufficient, though these commenters were split regarding whether the one opinion should be on management's assertion or on the subject matter. Other commenters suggested that an opinion stating that the material weakness had been eliminated, without the phrase "because the stated control objective is met" would be a better alternative, while others asked the Board to consider an opinion stating that the identified controls were effective because the stated control objective was met, without stating that the material weakness had been eliminated.

B12. A number of commenters expressed concern with the phrasing "the material weakness has been eliminated," including the use of that phrase in the auditor's opinion and in the title of the proposed standard. These commenters believed that terminology such as "elimination" or "eliminated" might be too definite a term that might mislead report users into believing that there were no remaining deficiencies in the internal control over financial reporting in the area related to the specified material weakness, even though control deficiencies of a lesser severity than a material weakness might persist.

B13. After considering these suggestions, the Board decided to retain a single opinion on the subject matter and to revise the opinion wording. The Board continues to believe that a single opinion expressed directly on the subject matter is the simplest and clearest form of communication related to this engagement. Further, the Board believes that an auditor's opinion directly on the subject matter (i.e., the material weakness itself) will best achieve the overarching objective of this engagement—to clearly communicate as of an interim date auditor assurance about whether a previously reported material weakness continues to exist.

B14. The Board agreed with commenters that use of the term "elimination" might increase the risk that a report user would misunderstand the assurance provided by an auditor's opinion on a previously reported material weakness. As a result, the Board changed the form of the opinion to "In our opinion, the material weakness described above no longer exists as of [date of management's assertion]" and the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist." The text of the standard was modified throughout to delete references to "eliminated" or "elimination" and to reflect wording consistent with the revised opinion and title.

As-of Date of Report

B15. The proposed standard provided for significant flexibility by allowing the engagement to be undertaken at any time during the year, limited only by implications associated with the nature of the material weakness. In other words, the proposed standard did not require the engagement to be performed in conjunction with an audit or review of financial statements. Instead, the proposed standard required the auditor to determine whether management had selected an appropriate date for its assertion and specified several matters for the auditor to consider in making this determination.

B16. A number of auditors suggested that the engagement described by the proposed standard should be performed only as of quarterly financial reporting dates instead of as of any date during the year. These commenters believed that such a requirement would allow the auditor to integrate this work with the auditor's interim review procedures under AU sec. 722, *Interim Financial Information*, and provide a link between the auditor's report on the material weakness and management's quarterly disclosures of material changes in internal control. Commenters noted that many of the material weaknesses that have been disclosed to date are related to the period-end financial reporting process and that the auditor would therefore need to test controls in connection with a period-end to determine whether the material weakness continues to exist. Several commenters linked their suggestion that this engagement be performed only as of a quarterly financial reporting date to the view that the standard's direction on performing substantive procedures as part of this engagement should be bolstered (see separate discussion on performance of substantive procedures beginning at paragraph B51). One commenter pointed out, however, that if this engagement could be conducted only in connection with a quarterly financial reporting date, special guidance for applying the standard to foreign filers would be necessary because foreign filers are not required to report quarterly in the same manner as domestic filers.

B17. The Board believes that the flexibility provided in the proposed standard regarding the timing of the engagement is an important and appropriate feature of the standard. Although the Board agrees with commenters' observations that many of the material weaknesses disclosed during the past year were related to the period-end financial reporting process, the Board determined that the existing provisions of the proposed standard address this circumstance. In determining whether management has selected an appropriate date for its assessment, the standard requires the auditor to consider that controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

B18. Moreover, some material weaknesses—such as those that involve transaction-based controls that operate daily—are well suited for a management assertion and an auditor opinion that the material weakness no longer exists as of almost any date. Restricting an auditor's reporting on whether a material weakness continues to exist to only quarterly financial reporting dates could impose unnecessary delay on a company seeking auditor assurance that this type of material weakness no longer exists. For example, assume that a calendar year-end company had previously disclosed a material weakness that was the type that would lend itself well to reporting that it no longer existed as of any date. Further, management could not yet assert that the material weakness no longer existed as of March 31, but believed that it could make the assertion as of a date in April. If the standard restricted auditor reporting to a quarterly financial reporting date, the auditor would have to wait until June 30 to be able to attest to whether the material weakness continued to exist (and, presumably, would not be able to issue his or her report until July, at the earliest). While management could, in this example, provide timely disclosure to investors that the material weakness no longer existed, the Board concluded that structuring the provisions of the standard to potentially result in this kind of delay in auditor assurance would not serve the public interest.

B19. In light of these considerations, the Board decided to retain the provisions of the proposed standard that would permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B20. At least one auditor asked for clarification about whether a report issued pursuant to Auditing Standard No. 2 that identified a material weakness could be issued at the same time as a report pursuant to this standard indicating that the material weakness no longer exists as of a later date. The degree of flexibility regarding the timing of this engagement would permit the company (depending on the company's ability to assert that a material weakness no longer exists and the auditor's ability to timely audit that assertion) to simultaneously distribute its annual reports and the management assertion and auditor report described in this standard. Consistent with this flexible approach, nothing in this standard or Auditing Standard No. 2 would preclude the auditor from issuing a single, combined report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2 and the results of an engagement performed pursuant to this standard.

Applicability of the Standard to Material Weaknesses Not Previously Reported

B21. The proposed standard was structured to allow an auditor to report only on a previously reported material weakness. The proposed standard defined a previously reported material weakness as a material weakness that was previously described by an auditor's report issued pursuant to Auditing Standard No. 2. A material weakness initially identified *after* the company's annual assessment date could not, therefore, be the subject of an auditor's report under the proposed standard.

B22. *V*irtually all of the investors who submitted comment letters suggested that the standard should allow for auditor reporting on material weaknesses identified subsequent to the company's most recent annual assessment of internal control over financial reporting. Although some of these commenters expressed concern about the level of work that might be required of the auditor to thoroughly understand a material weakness not previously reported upon by an auditor, they did not believe that the standard should prohibit such reporting. One commenter stated that if a successor auditor could gain an understanding of a company's internal control sufficient to report on a material weakness that was identified and reported on by a predecessor auditor, an auditor should be able to gain the understanding necessary to report on a material weakness identified by management as of an interim date.

B23. The majority of the auditors who commented indicated strong opposition to allowing auditors to report in this engagement on material weaknesses not previously reported. These commenters suggested that the initial identification of a material weakness requires a level of understanding of the company's controls and the specific facts and circumstances surrounding the material weakness that can result only from a complete evaluation of the effectiveness of internal control over financial reporting. Additionally, at least one commenter expressed concern that the identification of a material weakness subsequent to the annual assessment is a strong indicator of a material change within the company's internal control over financial reporting. This commenter believed that in such a circumstance the auditor would not have sufficient knowledge of the current state of internal control over financial reporting to be able to consider the interaction and potential implications of the change on other controls. This commenter also believed that this situation would prevent the auditor, in most cases, from being able to determine whether the newly identified material weakness no longer exists.

B24. The Board decided to retain the approach described by the proposed standard. The Board believes that the issue of a newly identified material weakness being an indicator of a material change within a company's internal control over financial reporting is a valid concern. Although the change in internal control over financial reporting giving rise to any new material weakness may be confined specifically to the area in which the material weakness originally was identified, the change also could be more far-reaching. In such circumstances, the auditor may not be able to determine the effect of the change without performing a full audit of internal control over financial reporting.

B25. The Board also notes that there is an important distinction between material weaknesses previously identified in an auditor's report issued pursuant to Auditing Standard No. 2 and other newly identified material weaknesses. The primary purpose of the narrow engagement described by this standard is to establish a timely and reasonable mechanism that a company can use to remove any perceived "stain" upon its financial reporting due to an outstanding adverse audit opinion on internal control over financial reporting that identified a material weakness. In the case of a new material weakness that is identified and addressed by management as of an interim date, an adverse auditor opinion previously attesting to the material weakness would not exist and, therefore, the new material weakness would not be the subject of the same type of market focus.

B26. There is also a fundamental difference between the auditor reporting on a material weakness not previously reported and a successor auditor reporting on a material weakness that *was* reported in a predecessor auditor's opinion on internal control over financial reporting. The fundamental difference is the concept of material change described above. The successor auditor must obtain a sufficient understanding of the company's internal control over financial reporting to report on the existence of a material weakness that was previously reported. This successor auditor, however, has the benefit of knowing that the material weakness was identified in the context of an audit of the internal control over financial reporting as a whole and that the predecessor auditor should have adequately described the nature of the material weakness (particularly its pervasiveness and the extent of its effect on the company's financial reporting). In contrast, in situations in which a material change has taken place and a new material weakness has arisen after the previous annual assessment of internal control over financial reporting, neither the predecessor nor the successor auditor has obtained this level of understanding as it relates to the newly identified material weakness.

B27. These considerations, taken together, resulted in the Board's decision to retain the provisions of the proposed standard that limit this engagement only to material weaknesses that have been previously described in an auditor's report issued pursuant to Auditing Standard No. 2. The Board also made changes to the standard, as suggested by one commenter, to make these provisions clearer. These changes included changing the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" as well as conforming changes to the text of the standard to refer explicitly to a *previously reported* material weakness as the subject matter of this engagement.

Focus on Control Objectives

B28. The proposed standard focused on stated control objectives to determine whether a material weakness continues to exist and posited that if a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. Because the term "stated control objective" was not precisely defined elsewhere in the Board's auditing standards, the proposed standard provided a definition as well as examples of stated control objectives.

B29. A *stated control objective* in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. The stated control objective would provide management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist. For this reason, the proposed standard required that management and the auditor be satisfied that if the stated control objective were achieved the material weakness would no longer exist.

B30. Comments on the proposed standard's focus on control objectives came primarily from auditors. Many auditors, either explicitly or implicitly, supported the focus on control objectives. One auditor suggested that, given the importance of control objectives, the proposed standard should explicitly state that documentation of control objectives is required.

B31. Several auditors, however, expressed concerns about the proposed standard's focus on control objectives. A couple of these commenters suggested that the proposed standard's emphasis on control objectives might inappropriately establish a framework for evaluating the effectiveness of internal control over financial reporting that differs from, or otherwise adversely affects the proper application of, the Committee of Sponsoring Organizations of the Treadway Commission's publication *Internal Control – Integrated Framework* ("COSO").

B32. Most concerned commenters expressed apprehension that report users might be misled by an auditor's opinion that a material weakness had been eliminated because the control objectives had been met. They believed that this type of opinion might lead report users to mistakenly believe that if the control objectives were met, there were no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness—when, in fact, a significant deficiency or deficiency could continue to exist.

B33. Another commenter noted that the examples in the proposed standard illustrated only control objectives for the control activities component of internal control over financial reporting—not for the other components (control environment, risk assessment, monitoring, information and communication). This commenter suggested that examples of control objectives in the other components would be helpful. Another commenter suggested that, given the importance of the control objective concept, if the

Board's standards were to specifically address the concept, such a definition and discussion should reside in Auditing Standard No. 2. One concerned auditor concluded that, given the importance of control objectives, more guidance was needed, including clarification that if more than one control is necessary to achieve a stated control objective, all such controls must be identified and tested as part of this engagement.

B34. In response to comments, the Board decided to retain the definition of, and focus on, control objectives and provide additional guidance. The Board views the auditor's use of the concept of control objectives as analogous to the use of the concept of relevant assertions. The concept of relevant assertions was already familiar to experienced auditors and was specifically defined for the first time in Auditing Standard No. 2 because of that standard's focus on testing controls over all relevant assertions related to all significant accounts. Similarly, the concept of control objectives is familiar to most experienced auditors and is already used to describe the auditor's responsibilities under Auditing Standard No. 2).[6/] A definition of control objectives (and stated control objectives) is provided in this standard because of the standard's focus on control objectives as a specific measure for determining whether a material weakness continues to exist. This is consistent with the Board's objective for its standards to be clear as well as the focus on control objectives in the engagement described by this standard.

B35. The Board believes that the standard's focus on control objectives is sound and helpful and is an appropriate complement to the control criteria, such as COSO, for the purposes of this engagement. 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 to be applied to the facts and circumstances in a reasonable and appropriate manner. Accordingly, the emphasis in this standard on control objectives is consistent with, and supports a correct application of, COSO.

[6/] For example, paragraph 12 of Auditing Standard No. 2 states, "Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." Paragraph 85 of Auditing Standard No. 2 elaborates on this idea, including the example that, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. That paragraph concludes with the statement, "When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the [deficient] preventive control relates." Perhaps most notably, paragraph 88 of Auditing Standard No. 2 requires the auditor to identify the company's control objectives in each area and identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.

B36. The focus on whether the stated control objectives have been met as the target for determining whether a material weakness continues to exist does accommodate the circumstance in which a deficiency or significant deficiency continues to exist in that area of the company's internal control over financial reporting. Although several commenters linked this result with the focus on control objectives, this potential result would exist in any case within the overall construct of this standard, completely apart from the focus on control objectives. The potential for less severe deficiencies to persist in an area in which a previously reported material weakness no longer exists parallels the reporting results of an engagement performed under Auditing Standard No. 2. According to that standard, only material weaknesses (not less severe weaknesses) are disclosed in an auditor's report and only the existence of a material weakness and not less severe weaknesses affects the auditor's opinion on the effectiveness of the company's internal control over financial reporting. As an illustration, assume that a company that had previously reported a material weakness in internal control over financial reporting elected to wait until the auditor's next annual report issued pursuant to Auditing Standard No. 2 to obtain auditor assurance related to the existence of the material weakness. If the control weakness that had previously risen to the level of material weakness were reduced to a significant deficiency or deficiency as of the company's next year-end, the auditor's next report issued under Auditing Standard No. 2 would present an unqualified opinion indicating that the company's internal control over financial reporting was effective. The Board concluded that the users of an auditor's report on whether a previously reported material weakness continues to exist need only receive auditor assurance that the material weakness no longer exists and not more detailed information about whether less severe control deficiencies continue to persist.

B37. The Board notes, however, that paragraph 140 of Auditing Standard No. 2 states (in part) that strong indicators of a material weakness include circumstances in which significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. An auditor is not required to provide an opinion under this voluntary engagement, and could reasonably decline to provide an opinion under such circumstances.

B38. In response to comments that report users will mistakenly believe that an auditor's report issued pursuant to the standard's provisions is communicating auditor assurance that no control deficiencies exist in the area related to the former material weakness, the Board decided that the change in the title of the standard and the form of the auditor's opinion (discussed further in paragraph B14), coupled with this discussion, would sufficiently mitigate any potential for report users to misunderstand the assurance being provided by an engagement conducted under the this standard. Removing the concept of control objectives from the standard would not address the potential for misunderstanding because this potential exists independently of the focus on control objectives.

B39. With regard to the recommendation that the standard provide additional examples of stated control objectives, including stated control objectives related to components of internal control over financial reporting other than control activities, the Board determined that the provisions of the standard should remain largely at the conceptual level and state that the other components of internal control over financial reporting can be expressed in terms of control objectives. The Board also determined to emphasize, in the note to paragraph 17 of the standard, that when a material weakness has a pervasive effect on the company's internal control over financial reporting, it may be difficult to identify all of the relevant control objectives and the material weakness probably is not suitable for this type of narrow, interim reporting.

B40. For the purposes of this engagement, a stated control objective need not be more precise than to describe an objective that relates to whether there is a more than remote risk that the company's financial statements are materially misstated in a given area. For instance, paragraph 14 of the standard includes the example control objective, "The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example assumes that the product X inventory account related to the company's Dallas, TX warehouse represents a more than remote risk of material misstatement to the company's financial statements taken as a whole and has been identified as a separate significant account. This example does not suggest that a company should establish separate control objectives for all of its various types of inventory, by inventory location, regardless of materiality.

B41. Although the Board believes that the proposed standard made clear that in performing this engagement, the auditor should identify and test all controls necessary to achieve the stated control objective, based on the importance of this concept and in response to commenters, the Board concluded that an explicit clarification should be added. Not only must newly implemented or modified controls be identified and tested in this engagement, but *all* controls necessary to achieve the stated control objective must be identified and tested. For example, in a circumstance in which four controls must operate effectively for a given control objective to be achieved, the failure of one of those controls could result in a material weakness. In the context of this engagement, all four controls necessary to achieve the stated control objective would need to be specifically identified and tested. This must be the case because of the inherent limitations in internal control over financial reporting. If three of the four controls were found to be effective as of year-end, they cannot be assumed to be effective as of a later date. To render an opinion as of a current date about whether the material weakness exists, the auditor must have current evidence about whether all controls (in this example, all four controls) necessary to achieve the control objective are designed and operating effectively.

B42. Regarding the suggestion to include a requirement that control objectives be documented, the Board notes that neither COSO nor Auditing Standard No. 2 currently contain such a requirement. As with many aspects of assessing the effectiveness of internal control over financial reporting, the better the documentation, the easier and more efficient the evaluation, especially from the auditor's perspective. In the context of this engagement, by virtue of creating a stated control objective, the company and the auditor would document the stated control objective, even if that documentation appeared only in their respective reports. Therefore, documentation is effectively required for the stated control objectives encompassed by an engagement conducted under this standard. The Board does not believe, however, that establishing a broad requirement for documenting *all* control objectives related to a company's internal control over financial reporting is needed at this time or would be appropriately placed within this standard.

Concept of Materiality

B43. To provide direction on the concept of materiality, the proposed standard largely referred to Auditing Standard No. 2. The proposed standard stated that 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 whether a previously reported material weakness continues to exist. 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.

B44. Several auditors commented that the proposed standard should provide additional direction on how the auditor considers materiality in performing this engagement. Commenters believed that clarification was necessary regarding the appropriate time context for management's and the auditor's materiality judgments. These commenters asked whether materiality should be assessed as of the date management asserts to be the date at which the material weakness no longer exists, or as of the end of the prior year when the material weakness was originally reported.

B45. Most commenters on this issue suggested that the date for assessing materiality should be the date management asserts to be the date at which the material weakness no longer exists. Commenters noted, however, that this position would allow a material weakness to no longer exist merely as a result of a business acquisition or disposition, for example, because either of those actions would change materiality as of that point in time (and, in the case of a disposition, send the material weakness along with the disposed business).

B46. Several auditors suggested that the auditor's opinion should explicitly recognize the concept of materiality. Commenters suggested the following as alternatives that would recognize materiality: "Management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated, in all material respects . . ." and "XYZ Company has eliminated the material weakness with respect to the Company's internal control over financial reporting as described above as of [*date specified in management's assertion*], in all material respects." These commenters were concerned that the opinion described by the proposed standard misrepresented the precision of the auditor's assessment and neglected the notion of reasonable assurance.

B47. The Board decided that the provisions in the standard regarding materiality should be clarified to specify that materiality should be assessed as of the date management asserts that the material weakness no longer exists. The as-of date of management's assertion and the auditor's opinion is fundamental to the auditor's decisions about whether he or she has obtained sufficient evidence to support an opinion and to the auditor's evaluation of that evidence to form an opinion on whether the material weakness exists as of that point in time. The Board believes that the logical and internally consistent position regarding the time context for assessing materiality is to assess materiality as of the date that management asserts the material weakness no longer exists. The Board also believes that materiality can be assessed as of a date other than a financial reporting period-end. This is consistent with the Board's decision, discussed further beginning at paragraph B15, that the standard permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B48. The Board also believes that auditors should exercise caution in circumstances in which the only aspect of a previously reported material weakness that has changed is materiality (in other words, the size of the financial statement accounts has changed due to an acquisition or other activity rather than any changes in the design or operation of controls). In many such cases, the company will have undergone significant changes, with an associated change in internal control over financial reporting overall. In this circumstance, the auditor would need to perform procedures beyond the scope of work ordinarily contemplated under this standard to have a sufficient basis for his or her new assessment of materiality and an adequate understanding of the company's internal control over financial reporting overall. The Board believes that, in many cases in which the company has undergone a change of this magnitude, the auditor would need to perform a full audit of internal control over financial reporting in accordance with Auditing Standard No. 2 to have a sufficient basis for assessing materiality, understanding the company's internal control over financial reporting overall, and rendering an opinion about whether a material weakness continues to exist. Also, as discussed in paragraph B37, a previously reported material weakness may no longer exist because it has been reduced to a significant deficiency. In this circumstance, if management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness.

B49. Regarding the form of the auditor's opinion and concerns that the opinion suggested by the proposed standard implied an inappropriate degree of precision and neglected the concept of reasonable assurance, the Board concluded that the provisions of the proposed standard were sufficiently clear that the auditor's objective in this engagement was to plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist as of the date specified by management. Furthermore, the auditor's report described by the proposed standard included disclosure of this objective. The Board does not, therefore, believe that report users would mistakenly believe that the auditor's opinion, as proposed, would convey absolute assurance.

B50. In addition, the Board believes that including another reference to materiality in the auditor's opinion would not add anything of substance to the auditor's conclusion and could instead impair its readability. The determination of whether a material weakness exists is inherently linked to materiality. Stating that the material weakness no longer exists in all material respects would be redundant—the equivalent of saying that the financial statements are not materially misstated in all material respects. Accordingly, the Board has not added another reference to materiality in the auditor's opinion.

Performance of Substantive Procedures

B51. The proposed standard, consistent with its reliance on the existing provisions of Auditing Standard No. 2, focused largely on the tests of controls that the auditor must perform to obtain reasonable assurance that a material weakness no longer exists. The proposed standard additionally recognized that, in some cases, the auditor also would need to perform substantive procedures on account balances to obtain sufficient evidence as to whether a material weakness no longer exists.

B52. Several auditors believed that the proposed standard was too mild in its wording that the auditor "may determine" that performing substantive procedures was necessary. Those commenters believed that, to be consistent with the integrated audit concept of Auditing Standard No. 2 and to reflect the fact that identification of many material weaknesses during the past year occurred during the performance of substantive audit procedures, such wording did not adequately convey the importance of performing substantive procedures in an engagement to report on whether a previously reported material weakness continues to exist. Some commenters recommended that the standard set forth a presumptively mandatory requirement for the auditor to perform substantive audit procedures in all cases, while others suggested that strengthening the language or providing additional guidance about when substantive procedures are necessary would be sufficient.

B53. The Board continues to believe that in some circumstances, substantive procedures will not be necessary for the auditor to obtain sufficient evidence about whether a material weakness continues to exist. Like many aspects of this standard, the auditor's judgment in this area will depend on the nature of the material weakness. An auditor can obtain sufficient evidence to support an opinion on whether some material weaknesses continue to exist without the need for substantive procedures. Other material weaknesses necessitate substantive procedures for the auditor to obtain sufficient evidence. Therefore, the Board determined that it would be inappropriate to establish a presumptively mandatory requirement that substantive procedures be performed in all cases.

B54. The Board agreed, however, that the proposed standard did not sufficiently stress the potential importance of performing substantive procedures, depending on the nature of the material weakness. Paragraph 34 of the standard has, therefore, been modified in a manner that the Board believes better articulates the potential need to perform substantive procedures. An example also has been added to this paragraph of the standard to illustrate a circumstance in which substantive procedures ordinarily would need to be performed.

Using the Work of Others

B55. Similar to PCAOB Auditing Standard No. 2, the proposed standard permitted 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 applied the framework for using the work of others described in PCAOB Auditing Standard No. 2. That 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 persons performing the work.

B56. 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. 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. In contrast, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion as to whether a material weakness no longer exists would need to be applied at the control objective level.

B57. There were few comments on the provisions for using the work of others in this proposed standard. Most commenters who commented on these provisions expressed confusion about a passage in the example of proposed paragraph 36, which stated that "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." Commenters believed that walkthroughs were required in the proposed standard in all cases and that walkthroughs must be conducted by the auditor himself or herself.

B58. One auditor suggested clarifying within the proposed standard that the auditor will be able to use the work of others only in limited circumstances. This same commenter also believed that the bank reconciliation example presented in the proposed standard to illustrate how the auditor could use the work of others in this type of engagement was too simplistic and requested additional, more realistic examples.

B59. The Board continues to believe that the framework for using the work of others that was established in Auditing Standard No. 2 is appropriate for use in this context and, therefore, the provisions for using the work of others in the standard have been retained as proposed. At the same time, the Board determined that it would be helpful to clarify, through the following discussion, that the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on whether a material weakness continues to exist would need to be applied at the control objective level. A complete understanding of this feature of the standard is important because this provision allows for additional flexibility in the auditor's work.

B60. The auditor's opinion in this engagement is expressed only on whether the material weakness continues to exist—not on whether the individually identified controls are effective. As a result, the evaluation as to whether the auditor has obtained the principal evidence supporting his or her opinion should be made at the control objective level—not at the lower level of the controls individually identified in management's assertion and the auditor's report.

B61. If, for example, management's and the auditor's reports identify three separate previously reported material weaknesses that no longer exist, the auditor would, in effect, be rendering three separate opinions. Those opinions would indicate that each of the three individual material weaknesses continues to exist or no longer exists as of the date of management's assertion. The standard, therefore, would require the auditor to obtain the principal evidence that the *control objectives* related to each of the three identified material weaknesses were now achieved. However, the standard would not require that the auditor obtain the principal evidence that each *control specifically identified* in management's assertion as achieving the control objectives is effective.

B62. Auditing Standard No. 4 follows the same framework for using the work of others as Auditing Standard No. 2. There may, however, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The Board believes that no additional specific restriction on the use of the work of others is appropriate or necessary in the context of this engagement. Such a restriction would diminish the flexibility that the framework otherwise provides and perhaps inhibit the auditor's exercise of the judgment necessary to implement the framework appropriately. Furthermore, the Board does not believe that auditors need such direction within the standard to make appropriate decisions about using the work of others in this context.

B63. Similarly, the Board determined that no further examples of using the work of others were needed. The Board believes that additional examples demonstrating the application of the provisions in the standard for using the work of others to reflect more realistic (i.e., complex, fact-driven) situations is better handled outside of the standard itself and by auditors—in their audit methodology, training courses, and other venues.

B64. In response to confusion about the requirement for walkthroughs, the Board clarified the standard by adding a note to paragraph 38 and deleted the reference to a walkthrough from the example on using the work of others. Walkthroughs are required only of a successor auditor when the successor auditor performs this engagement before performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2. A continuing auditor that has opined already on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment and is engaged to conduct this narrow engagement is not required to perform any walkthroughs as part of this engagement.

Dividing Responsibility

B65. Due to the narrow scope of an engagement to report on whether a material weakness continues to exist, the provisions of the proposed standard allowed the principal auditor to use the work and reports of another auditor as a basis, in part, for his or her opinion. The proposed standard also prohibited the principal auditor from dividing responsibility for the engagement with another auditor.

B66. Very few comments were received on this provision of the proposed standard. One auditor suggested that, although dividing responsibility may not be appropriate in certain circumstances, the standard should not prohibit it. Another auditor expressed confusion about whether the principal auditor could refer to the report of the other auditor but not divide responsibility with the other auditor.

B67. The Board continues to believe that, based on the nature of the engagement described by the standard, the principal auditor should be prohibited from dividing responsibility for the engagement with another auditor. The Board's consideration of the nature of this engagement included recognition of the narrow scope of the work (i.e., whether a previously reported material weakness continues to exist), that the engagement would be voluntary, and that the assignment would be non-recurring (unlike the recurring nature of the audit of the financial statements or the audit of internal control over financial reporting). The Board notes that three appropriate alternatives exist in the circumstance in which another auditor is involved and the company wants to obtain auditor assurance that a previously reported material weakness no longer exists:

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by performing all of the testing required for this engagement himself or herself.

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by using the work and reports of another auditor as a basis, in part, for his or her opinion, and by taking responsibility for the work performed by the other auditor. In this case, the auditor may not make reference to the other auditor in his or her report on whether a previously reported material weakness continues to exist.

- The company could wait until year-end when the principal auditor would report on the effectiveness of internal control over financial reporting overall under the provisions of Auditing Standard No. 2.

B68. The Board concluded that the standard was sufficiently clear that the principal auditor could not divide responsibility with another auditor and, therefore, that the auditor also could not refer to the other auditor in his or her report. Accordingly, no change has been made to the standard in this regard.

New Material Weaknesses Identified

B69. The proposed standard was silent regarding the auditor's responsibilities if, during the performance of this engagement, he or she became aware of a new material weakness not previously reported on by an auditor.

B70. Several commenters requested that the standard address the auditor's responsibilities for new material weaknesses identified during this engagement and suggested what these responsibilities should be. One investor suggested that the standard should require the auditor to include disclosure of any new material weaknesses of which the auditor was aware in his or her report. This commenter stated that, otherwise, the auditor's report would become a way of telling investors the good news while concealing the bad news. Another commenter suggested that management should be required to include the new material weakness in management's assertion that would accompany the auditor's report and the auditor should then disclaim an opinion on the new material weakness.

B71. Both the identification of material weaknesses and the remediation of such weaknesses will be captured by management's voluntary and required reporting under the SEC's rules. Accordingly, the provisions of this standard do not facilitate management's ability to conceal from investors the emergence of a new material weakness at the company. Nevertheless, the Board agreed that when an auditor identifies a new material weakness during the performance of this engagement, the auditor should not simply remain silent. Accordingly, the Board modified the standard to require the auditor to communicate, in writing, to the audit committee any material weaknesses identified during this engagement that the auditor had not previously communicated, in writing, to the audit committee.

B72. The existing provisions of Auditing Standard No. 2 contain responsibilities for the auditor if (1) information comes to the auditor's attention during this engagement that leads him or her to believe, while performing quarterly procedures required by Auditing Standard No. 2, that management's quarterly disclosures are materially misleading, or

(2) the auditor becomes aware of conditions that existed at the date of his or her last report issued under Auditing Standard No. 2.

B73. Paragraphs 202-206 of Auditing Standard No. 2 establish certain requirements for the auditor related to management's quarterly and annual certifications with respect to the company's internal control over financial reporting. If matters come to the auditor's attention during this engagement that lead him or her to believe, while fulfilling these quarterly requirements, that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and the SEC's rules, these provisions of Auditing Standard No. 2 require the auditor to take action. Such actions escalate from auditor communications with management and then to the audit committee, culminating in the auditor considering his or her additional responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

B74. In addition, a continuing or predecessor auditor would have responsibilities under paragraph 197 of Auditing Standard No. 2 if the existence of a new material weakness came to the auditor's attention. This paragraph effectively extends the responsibilities in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, to reports on the effectiveness of internal control over financial reporting issued pursuant to Auditing Standard No. 2. The identification of a new material weakness in the current year would cause the auditor, in fulfilling these responsibilities, to determine whether the facts relating to the material weakness existed at the date of the auditor's report pursuant to Auditing Standard No. 2 and, if so, (1) whether those facts would have changed the auditor's report issued under Auditing Standard No. 2 if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. If the auditor determined that the new material weakness identified in the current year actually existed as of the date of his or her previous report under Auditing Standard No. 2 and that it was not adequately identified and disclosed in that report, the auditor would need to take steps such as recalling and reissuing the previous report to ensure that investors did not continue to rely on the previously issued (erroneous) report.

B75. Including newly identified material weaknesses in the auditor's report could potentially mislead investors into believing that the assurance provided by this type of engagement is broader than it actually is. If report users were provided with disclosure (covered by the auditor's opinion) of new material weaknesses of which the auditor was aware, report users might incorrectly believe that the auditor's report captured *all* new material weaknesses that had arisen at the company. Similarly, a requirement for the auditor to disclose any new material weaknesses could lead report users to conclude, incorrectly, that no such disclosure means that there is current auditor assurance over the whole of internal control over financial reporting at the company. The objective of this engagement is to provide auditor assurance about whether a previously reported material weakness continues to exist—nothing broader. The only way for investors to obtain a more complete report from the auditor would be for the auditor to audit internal control over financial reporting in accordance with Auditing Standard No. 2.

Specific Identification of All Previously Reported Material Weaknesses

B76. The proposed standard required the auditor to modify his or her report if the auditor provides assurance on less than all of the material weaknesses previously reported. The proposed standard did not, however, require the auditor to specifically identify all of the previously reported material weaknesses not covered.

B77. All investors who commented on this issue suggested that all material weaknesses previously reported either should be referred to or specifically included in the auditor's report. They indicated that failure to identify the additional material weaknesses might lead some users to erroneously conclude that they no longer exist. Auditors, on the other hand, agreed that complete specific identification of the previously reported material weaknesses not covered by the auditor's opinion should not be included, primarily because they believe that it may increase the risk of confusion about the scope of the engagement and what is being covered in the auditor's opinion. Several commenters who agreed that specific identification was not necessary suggested that in addition to the report modification included in the proposed standard, the auditor's report on this engagement should specifically direct the reader to the previous auditor's report (issued under Auditing Standard No. 2), by either attaching a copy of the audit report or by providing direction as to where the report could be obtained.

B78. The Board believes that including a complete specific identification of the previously reported material weaknesses not covered by this engagement would prove problematic. As noted by many commenters, it is possible that including this detail would confuse report readers regarding the scope of this narrow engagement and could imply that, unless told otherwise, a report user should assume that those other material weaknesses *do* continue to exist. In some of the material weakness descriptions included in management's and the auditor's reports on the effectiveness of the company's internal control over financial reporting as of year-end, the description of multiple material weaknesses covered several pages. That level of detail in an auditor's report specifically targeted at whether just one material weakness continues to exist could easily overwhelm the rest of the audit report, making the report prone to various kinds of misinterpretations.

B79. The Board concluded that report readers would be better served by requiring the auditor to provide information regarding where to obtain the previously issued audit report—either by attaching it or referring to where it could be publicly obtained.

Other Reporting Matters

B80. *No Requirement to Issue a Report*. The proposed standard required that the auditor, if he or she concluded that the material weakness continues to exist, communicate that conclusion in writing to the audit committee. The proposed standard, however, did not require the issuance of a report. Rather, the proposed standard recognized that the auditor must consider this knowledge in connection with the auditor's responsibilities under Auditing Standard No. 2 to determine whether management's quarterly disclosures about internal control over financial reporting are not materially misleading.

B81. Several auditors who commented recommended that the proposed standard should require the auditor to issue an adverse report in the event that the auditor concludes that the material weakness continues to exist. One suggested that issuance of an adverse report would be necessary only if the auditor believed that the company had previously publicly disclosed that the material weakness had been addressed.

B82. The Board continues to believe that requiring the issuance of an adverse report to the company would serve no useful purpose in this circumstance because the company might not make such a report public. The Board believes, therefore, that requiring the auditor to communicate, in writing, with the audit committee his or her conclusion that a material weakness that was the subject of this engagement continues to exist would serve the same purpose as requiring the issuance of an adverse report. At the same time, such a requirement would provide the auditor with additional flexibility as to the form of communication that would be most meaningful to the audit committee. Regarding the potential for management to lead investors to incorrectly believe that the material weakness no longer exists in its public disclosures, the Board believes that the federal securities laws, as well as auditor's existing responsibilities related to management's quarterly disclosures, are adequate safeguards to protect investors from misleading information.

B83. *No Distinction in Standard Between Unqualified and Adverse Opinion*. As discussed in the note to paragraph 43 of the standard, the standard no longer distinguishes between an unqualified and an adverse opinion. The auditor's opinion was revised to state that the material weakness exists or no longer exists. This revision is discussed further in the section "Form of Auditor's Opinion" and is now referred to in the standard as the auditor's opinion.

B84. *Inherent Limitations*. The inherent limitations paragraph of the auditor's report provided in the proposed standard discussed the inherent limitations of internal control over financial reporting overall, rather than the inherent limitations of the controls related to the material weakness being reported on.

B85. One commenter suggested that the inherent limitations paragraph was too broad for this engagement and needed to be modified to more accurately reflect the narrow focus of this type of engagement.

B86. The Board agreed that the inherent limitations paragraph, in this context, should be targeted to the specific controls identified in this auditor report. In addition, the Board continues to believe that the broader concept of inherent limitations in internal control over financial reporting overall is equally applicable. The inherent limitations paragraph in the auditor's report has been modified to reflect both of these conclusions.

B87. *Obtaining an Understanding of Internal Control Over Financial Reporting.* The proposed standard included a required report element stating 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." This language also was included in the example report included in the proposed standard.

B88. Several auditors expressed concern that the phrase, "the engagement includes obtaining an understanding of internal control over financial reporting," implies that, as a part of the current engagement, the auditor spent a significant amount of time understanding internal control over financial reporting overall rather than carrying forward his or her understanding from the prior annual audit. These commenters believed this implication conflicted with the direction in the body of the proposed standard that 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 this engagement. One commenter acknowledged that the proposed wording may be appropriate in cases in which a successor auditor is performing this engagement without previously gaining that understanding.

B89. The Board continues to believe that an auditor who has audited the company's internal control over financial reporting as of the company's most recent annual assessment 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 whether a previously reported material weakness continues to exist. To require a continuing auditor to update and document his or her understanding of internal control over financial reporting overall (to the full measure required by Auditing Standard No. 2) would be unnecessarily burdensome and costly. The Board modified the report element for a continuing auditor to clarify that the auditor previously obtained an understanding of internal control over financial reporting overall at the company and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness.

B90. The Board continues to believe, however, that a successor auditor that has not yet audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 would need to obtain a current understanding of internal control over financial reporting in connection with this engagement. Therefore, the report element described in the proposed standard is appropriate and has been retained for a successor auditor's reporting.

B91. *Example Reports*. The proposed standard included only one example report, which illustrated reporting on one material weakness by a continuing auditor when no additional material weaknesses were reported previously. Several commenters requested modification of the standard to address circumstances that the Board believed were already addressed by the proposed standard but were not illustrated in the single example report. Some commenters also made specific requests for additional example reports.

B92. The Board determined, after considering the nature of the comments, that additional example reports, while not covering all possible situations, would provide additional clarity to the various reporting situations. The Board selected three reports to illustrate most facets of the reporting provisions of the standard. Appendix A includes those reports.

Conforming Amendments to AT sec. 101

B93. The proposed standard contained a proposed conforming amendment to AT sec. 101, *Attest Engagements*. The proposed conforming amendment would have required the proposed standard to be used, rather than AT sec. 101, for any engagements in which the subject matter is whether a material weakness continues to exist. This conforming amendment would have precluded the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement was whether a material weakness continues to exist.

B94. The Board received few comments related to the proposed conforming amendment. One auditor agreed that a conforming amendment to preclude a review-level attestation was appropriate when the subject matter was whether a material weakness continues to exist. This commenter went on to suggest, however, that there could be appropriate uses for an agreed-upon procedures engagement and that the Board should not preclude agreed-upon procedures from being performed under the Board's standards. Such reports, the commenter noted, would be restricted to the use of the specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes and, therefore, these reports would not generally be available to investors. Thus, these reports would not be a substitute for the engagements addressed in the proposed standard. Another commenter separately suggested broadly retaining the ability for the auditor to perform a review engagement when the subject matter is a previously reported material weakness.

B95. The Board continues to believe that investors and other report users in the public domain will be best served by the Board's standards permitting only positive assurance (i.e., an examination-level attestation) from the auditor when the subject matter is whether a material weakness continues to exist. The Board agrees, however, that private parties (such as audit committees) who wish to engage the auditor to perform specified procedures when the subject matter is whether a material weakness continues to exist should be allowed to negotiate such a private arrangement, as long as the results are not intended for public use. The Board, therefore, decided to modify the conforming amendment to AT sec. 101 of the Board's interim standards. As adopted, an auditor may not use AT 101 to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use.

Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Attestation Standards

AT sec. 101, Attest Engagements

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

Engagements in which the practitioner is engaged to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist.*

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rule

(a) Purpose

Section 404 of the Act requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the SEC's implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists. A company may determine that disclosure under the framework already provided by the federal securities laws is sufficient for this purpose. Some 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, adopted an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. <u>Board's Statement on Burden on Competition</u>

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule describes a voluntary engagement that would be available but not required for any company that previously reported a material weakness in internal control over financial reporting. The Board believes that, in some situations, companies will find that auditor assurance that a material weakness no longer exists leads to a higher level of investor confidence in the company's financial reporting and that the costs of the engagement are therefore worth incurring. If a company believes, however, that these benefits may be outweighed in a particular case by the costs, or that the engagement is otherwise not in the company's interest, the company may (and presumably would) determine not to engage its auditor to perform this work.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rule for public comment in Release No. 2005-002 (March 31, 2005). A copy of Release No. 2005-002 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board received 30 written comments. The Board has clarified and modified certain aspects of the proposed rule in response to the comments it received, as discussed in Appendix B, *Background and Basis for Conclusions*, to the proposed rule.

III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

(a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2005-01 and should be submitted within [ ] days.

By the Commission.

Secretary

PCAOB
Public Company Accounting Oversight Board

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

PROPOSED AUDITING STANDARD – REPORTING ON THE ELIMINATION OF A MATERIAL WEAKNESS	PCAOB Release No. 2005-002 March 31, 2005 PCAOB Rulemaking Docket Matter No. 018

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing an Auditing Standard, *Reporting on the Elimination of a Material Weakness*. If adopted, this standard would establish requirements and provide direction that applies when an auditor is engaged to report on the elimination of a material weakness.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the 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.

Board Contacts: Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org), Sharon Virag, Assistant Chief Auditor (202/207-9164; virags@pcaobus.org)

I. Background

A linchpin of the Sarbanes-Oxley Act of 2002 ("the Act") is Section 404, which requires a public company's management to provide the investing public with an assessment of the state of the company's internal control over financial reporting on an annual basis and a report of independent auditors attesting to management's assessment. While federal law has for over 25 years required that companies maintain

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 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 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

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;

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.

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

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

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

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;

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*;

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, 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

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.

PCAOB

Public Company Accounting Oversight Board

19b-4

Exhibit 2(a)(B)

Tab Number	Comment Source
1	Acumen Control ERP, Inc., Author: Bryan Wilson, CPA, CISA, 5-May-05
2	American Federation of Labor and Congress of Industrial Organizations, Author: Damon Silvers, Associates General Counsel, AFL-CIO, 16-May-05
3	Auditing Standards Committee of the Auditing Section of the American Accounting Association, Author: Roger D. Martin, University of Virginia, Chair, Robert Allen, University of Utah, Vice Chair, Dana R. Hermanson, Kennesaw State University Past Chair, Thomas M. Kozloski, Wilfrid Laurier University, Evelyn Patterson, University at Buffalo, Robert J. Ramsay, University of Kentucky, Stuart Turley, University of Manchester, 12-May-05
4	BDO Seidman, LLP, 16-May-05
5	California State Teachers' Retirement System, Author: Jack Ehnes, Chief Executive Officer, 16-May-05
6	Center for Public Company Audit Firms of American Institute of Certified Public Accountants, Author: Robert J. Kueppers, Chair, 16-May-05
7	Council of Institutional Investors, Author: Ann Yerger, Executive Director, 17-May-05
8	Crowe Chizek and Company LLC, 23-May-05
9	Deloitte & Touche, LLP, 16-May-05
10	Dennis R. Beresford, Ernst & Young Executive Professor of Accounting, J. M. Tull School of Accounting, The University of Georgia, 1-Apr-05
11	Enpria, Author: Victoria Whitlock, Compliance Practice Manager with support from J. Michael Hayes, Compliance Analyst, 16-May-05
12	Ernst & Young LLP, 16-May-05
13	Florida Institute of Certified Accountants, Author: Kathryn M. Means, CPA, Chairman FICPA Accounting Principles and Auditing Standards Committee, Lillian Conrad, Randy Dillingham, 16-May-05

19b-4

14	Government Accountability Office, Author: David M. Walker, Comptroller General of the United States, 9-May-05
15	Grant Thornton, LLP, 16-May-05
16	Greg Swalwell, 12-May-05
17	HSBC, Author: Douglas J. Flint, Group Finance Director, 12-May-05
18	Intel Corporation, Author: James G. Campbell, Vice President Corporate Controller, 16-May-05
19	KPMG, LLP, 16-May-05
20	McGladrey & Pullen, LLP, 15-May-05
21	Moody’s Investors Service, Author: Gregory J. Jonas, Managing Director, 11-May-05
22	National Association of State Board of Accountancy, Author: Michael D. Weatherwax, CPA, David A. Costello, CPA, President , 10-May-05
23	New York State Society of Certified Public Accountants, Author: John J. Kearney, President, 11-May-05
24	North Carolina State Board of CPA Examiners, Author: Leonard W. Jones, CPA, President, 16-May-05
25	Ohio Public Employees Retirement System, Author: Laurie Fiori Hacking, Executive Director, 15-Apr-05
26	Ohio Retirement Systems, Author: Damon F. Asbury, Executive Director State Teachers Retirement System of Ohio, Richard A. Curtis Executive Director Highway Patrol Retirement System, William J. Estabrook Executive Director Ohio Police and Fire Pension Fund, Laurie Fiori Hacking Executive Director Ohio Public Employees Retirement System, James R. Winfree Executive Director School Employees Retirement System of Ohio, R. Keith Overly Executive Director Ohio Public Employees Deferred Compensation, 26-Apr-05
27	Pricewaterhousecoopers, LLP, 16-May-05
28	State Board of Administration of Florida, Author: Coleman Stipanovich, Executive Director, 16-May-05
29	Texas Society of Certified Public Accountants, Author: C. Jeff Greg, CPA Chair, Professional Standards Committee , 11-May-05

PCAOB
Public Company Accounting Oversight Board

19b-4

30	The Association of the Bar of the City of New York, Author: N. Adele Hogan, Chair of Committee on Financial Reporting, Matthew J. Mallow, Chair of Committee on Securities Regulation , May 12, 2005

Bryan E. Wilson CPA, CISA
Acumen Control ERP, Inc.
Arlington, TX 76016

Sent via e-mail to: comments@pcaobus.org

May 5, 2005

Mr. J. Gordon Seymour, Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 018, Proposed Auditing Standard on Corrections of Material Weaknesses in Internal Control Over Financial Reporting

Dear Mr. Seymour:

I have read the Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness – and, in general, support the issuance of a standard that allows companies to report to its investors that an attest engagement has confirmed the remediation of a previously reported material weakness. The endorsed auditor communication that a material weakness has been eliminated may add credence to the recently adopted internal controls reporting regime proposed by the PCAOB and approved by the SEC (i.e., Audit Standard 2 (AS2)), provide investors and other interested parties with timely information they need to make prudent decisions, and encourage management to properly address material weaknesses prior to filing a 302 certification stating the resolution. Additionally, making this a voluntary standard should allay the fears of additional regulatory costs and truly moves toward a market-based approach.

I am concerned with the nature of the proposal as it relates to control objectives outlined in paragraphs 11, 12, 13 and 14. The definition provided in this proposal may detract from AS2's objective of a controls-based, integrated audit by producing a myriad of control objectives without increasing the confidence of an "… assessment,…, of the effectiveness of adequate internal control structure…."[1] Furthermore, the increased specificity may produce a public expectation that cannot be supported by the work performed and may ultimately result in a loss in public confidence in the audit process[2]. By not allowing auditors and companies to focus their risk assessment (and by extension control objectives) on the flow of transactions and events, companies and auditors may lose sight of the financial reporting risks associated with business process activities and related information processing systems, and instead focus attention on account balances that are only a reflection of previously processed transactions and events.

It appears that the PCAOB requires auditors, and companies by extension, to identify very specific control objectives that relate to the assertions relevant to account balances instead of the

[1] Sarbanes-Oxley Act of July 2002, Section 404 (a)(2)
[2] The Social Responsibility of the Auditor (1985), (Limperg Inisitituut, Inter-University Institute for Accountancy, Amsterdam, The Netherlands, 1985), p. 39

processes that generated the account balances.[3] Furthermore, the proposed definition requires a level of precision that goes beyond that required to maintain an effective internal control structure. For instance, paragraph 13 provides an example that states "The Company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example, if taken at face value, implies that companies would be required to detail out multiple permutations of control objectives. If a company had 30 locations that stored product X, would the company be required to identify 30 control objectives to cover the rights and obligations assertion for each inventory location? Add into the mix that the inventory accounts may have multiple assertions and you may have up to 210 control objectives[4]. This simple calculation does not take into consideration the multiple product lines or other financially significant accounts related to inventory; nor does it mention the potentially hundreds or thousands of accounts that could be subject to evaluation.

Paragraph 11 references AS2 paragraphs 68 to 70 as a source for understanding relevant assertions. These paragraphs correctly discuss relevant assertions for each significant account and explain how to evaluate whether an assertion is relevant for a given account. Furthermore, paragraph 12 references AS2 paragraph 88 which instruct the auditor to align controls with control objectives when evaluating the design effectiveness of controls. However, these paragraphs do not directly correlate financial statement assertions to control objectives.

The Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control – Integrated Framework* [5] report states the following:

> The factors representing fair presentation can be viewed as basic financial reporting objectives. These would be supported by sub-objectives represented by the financial statement assertions, which in turn are supported by related objectives identified with respect to an entity's various activities.

The COSO statement above explicitly states that the financial statement assertions (i.e., sub-objectives of fair presentations) are supported by various activity [or process or control] objectives. If a company has as one of its various activities inventory management, companies should be able to identify control objectives that control the process for managing inventory. This appeared explicit in AS2 paragraphs 40, 42. These paragraphs consistently state, among other objectives (e.g., the initiating and processing of non-routine and non-systematic transactions), that companies should identify controls over the initiating, authorizing, recording, processing and reporting of significant transactions.

Also, this control objective definition may conflict with other SEC and PCAOB regulations. For example, SEC and PCAOB regulations require a company to "…base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." Since COSO appears to be the framework of choice, this may result in companies altering the COSO

---

[3] AS 2 mentions the phrase control objective 10 times in paragraphs 8 (twice), 12, 40, 85, 86 (twice), 88, B23, E116.

[4] Although there are only 5 categories of Financial Statement assertions defined by COSO, the number of assertions applicable to an account may be 7 since the assertions of Existence, Occurrence, Valuation and Allocation may exist simultaneously for any given account.

[5] See COSO, Internal Control-Integrated Framework (1992) ("COSO Report"), p. 32

framework's intent that activity-level (or process or control) objectives support financial statement assertions which, in turn, support entity-level financial reporting objectives.

One other point worth mentioning is that the COSO report doesn't define "control objective" in the glossary or in the body of text itself. Also, the illustrative evaluation tools provided by the COSO report do not take the approach outlined in this proposal when identifying control objectives for various activities.

The COSO approach permits companies to outline their activity-level (or process or control) objectives based on a process framework. This approach recognizes that financial statement transactions enter a company's books and records through processes and do not appear by happenstance. Adopting the current definition of control objective may negate years of research and development in how best to obtain control (i.e., know) over processes that lead to financial reporting. For example, Peter F. Drucker states, "The purpose of control is to make the process go smoothly, properly, and according to high standards.[6]" The "high standards" are the financial statement assertions outlined in the Audit Standard 2. "Smoothly" and "properly" are recognized in the activity level objectives combined with the information processing objectives in COSO Chapter 4. Allowing companies and auditors to develop appropriate control objectives using a structured approach as provided in the COSO report will benefit society by allowing companies and auditors to focus on significant process risks.

This definitional change to the phrase "control objective" should be addressed in an addendum to Audit Standard 2 rather than this proposal. Doing so will allow external auditors and companies in general to ascertain the impact to their compliance efforts. I hope the feedback provided is constructive and applaud the standards developed by the PCAOB implementing SOA section 404.

I appreciate the opportunity to provide feedback and generally agree with the direction of auditor confirmation of remediated material weaknesses. If you need any additional information or have questions, please contact me at bwilson@acutrolerp.com.

Sincerely,

Bryan E. Wilson

[6] Peter F. Drucker, Management: Tasks, Responsibilities, Practices (HarperCollins Publishers, Inc. New York, 1973), p. 218

American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
www.aflcio.org

May 16, 2005

BY ELECTRONIC MAIL

Laura Phillips
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Comment on Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness (PCAOB Rulemaking Docket Matter No. 018)

Dear Ms. Phillips:

On behalf of the American Federation of Labor and Congress of Industrial Organizations, I welcome this opportunity to offer our comments on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed auditing standard which would establish requirements that apply when an auditor reports on the elimination of a material weakness.

The AFL-CIO is the federation of America's labor unions, representing fifty-seven national and international unions and their membership of 13 million working women and men. Union members participate in the capital markets as individual investors and through a variety of benefit plans. Union members' benefit plans have over $5 trillion in assets. Union-sponsored pension plans account for over $400 billion of that amount.

The AFL-CIO supports the PCAOB's creation of an auditing standard addressing interim reporting on the elimination of material weaknesses. This proposed auditing standard would create a mechanism by which companies may receive a report from their outside auditor on the correction of a material weakness in the most timely fashion possible. The alternative is the mistaken impression on the part of investors that a material weakness continues uncorrected until the next year's audit report.

However, a report on a corrected material weakness may in itself be misleading if not properly structured. We believe it is particularly important that there is a reference in any report of the kind contemplated by the proposed standard to any remaining uncorrected material weaknesses. Without such a reference, the report would communicate the false impression to investors that all material weaknesses had been corrected, and would encourage an inappropriately strategic use of this mechanism by companies.

In addition, and perhaps even more importantly, if this interim engagement led to the auditor becoming aware of a material weakness that had not been identified in the most recent audit, the auditor should be required to disclose that weakness as well. Otherwise, the interim report contemplated in the proposed rule becomes simply a way of telling investors only the good news while management and the auditor concealed bad news.

The concern has been raised that the requirement to mention continuing or new material weaknesses would discourage the use of this reporting process by companies. We suspect that the real value of the sort of reporting contemplated by the proposed standard is when all material weaknesses have been corrected. Fully informed investors are unlikely to respond to selective corrections of material weaknesses. The PCAOB should not facilitate misleading investors as to whether all material weaknesses have been corrected or not simply because companies may not like what investors do with the information.

The PCAOB has further requested comment on whether auditors should be allowed to report on the elimination of material weaknesses that had not been previously identified in the audit report but which are now corrected. We believe auditors should be allowed to so report, *but only if auditors are required to disclose uncorrected material weaknesses that have come to the attention of the auditor since the last audit report.*

Finally, the proposed standard provides that if an auditor determines that the material weakness has not been eliminated and is ordered to test again, the auditor would be required to communicate to the company's audit committee that the weakness had not been eliminated on the second occasion. We support this provision of the proposed rule, as in general we support regulations reinforcing the provisions of Sarbanes-Oxley that make clear the independent auditor works for the audit committee, not for the management of public companies.

We thank you for this opportunity to comment on this proposal. If you have any questions regarding our comments, please feel free to contact me at (202) 637-3953.

Sincerely,

Damon Silvers
Associate General Counsel, AFL-CIO

American Accounting Association ♦ Auditing Section
Auditing Standards Committee

May 12, 2005

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

Via email to comments@pcaobus.org

RE: Invitation to Comment on PCAOB Rulemaking Docket Matter No. 018

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on *Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness.* The views expressed in this letter are those of the Auditing Standards Committee members and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We offer our responses to the specific questions posed in section IX of the Board's Release No. 2005-002 dated March 31, 2005. We find the proposed rules and discussion to be very well constructed and consistent with existing Board and SEC requirements, and we compliment the Board on taking quick action to address this topic.

The Board invited comment on three specific issues:

1. Does the sample auditor's report, which is included in the proposed standard, clearly describe the results of the engagement?

   Yes. The sample report clearly describes the results of the engagement. The report seems to be consistent with what a user would expect based on the original audit report on the material weakness that would have been issued under AS No. 2.

2. 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?

No. A requirement to specifically identify the additional material weaknesses seems to increase the risk of confusion about the intent of the engagement and subsequent report.

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?

   No. Our view is that the purpose of this type of engagement and subsequent report is to allow the auditor to address material weaknesses identified in prior 404 reporting. If the auditor has not identified the item as a material weakness in a prior 404 engagement and report, it does not seem appropriate to report on the correction of that weakness in a separate report.

We hope that our suggestions are helpful and will assist in finalizing the auditing standard. Please feel free to contact our committee Chair for elaboration on or clarification of any comment.

Respectfully Submitted,

Auditing Standards Committee
Auditing Section, American Accounting Association

Committee Members:
Roger D. Martin, University of Virginia (Chair)
434-982-2182, rdm3h@virginia.edu
Robert Allen, University of Utah (Vice Chair)
Dana R. Hermanson, Kennesaw State University (Past Chair)
Thomas M. Kozloski, Wilfrid Laurier University
Evelyn Patterson, University at Buffalo
Robert J. Ramsay, University of Kentucky
Stuart Turley, University of Manchester

BDO Seidman, LLP

330 Madison Avenue
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

May 16, 2005

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

Re: PCAOB Rulemaking Docket Matter No. 018 – Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness

Dear Mr. Secretary,

BDO Seidman respectfully submits the following comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standard ("the proposed standard"), *Reporting on the Elimination of a Material Weakness*. We support the efforts of the PCAOB in responding to investor and company management concerns regarding the need for a mechanism to provide an objective third party assessment of management's disclosure concerning internal control improvements. The proposed standard advances the concepts of transparency, timeliness, and objectivity by providing a mechanism that facilitates a meaningful dialogue between company management and capital market participants. This dialogue is an integral component in the continuing efforts to rebuild investor confidence in financial reporting.

Overall, we support the major provisions of the proposed standard and appreciate the opportunity to respond to the questions posed by the Board. We provide our response to the questions posed by the Board in part IX of the release that accompanied the proposed standard, and have included an additional comment regarding documentation.

Responses to Questions Posed by the Board

PCAOB Question 1: 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?

In our view the sample auditors' report should include the following items to better clarify the scope of the work performed and conclusions reached based on the audit work performed.

Wording of Report

To appropriately describe and report on the resolution of a material weakness in the type of engagement contemplated in the proposed standard, we propose that the opinion paragraph in the report be modified to describe the circumstances in which the material weakness has been resolved as follows:

BDO Seidman, LLP

330 Madison Avenue
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

> "In our opinion, the material weakness described above as of [date of management's assertion] no longer exists due to [describe the actions or circumstances which caused the material weakness to no longer exist]"

We believe this wording more clearly communicates to the reader that the material weakness that was previously reported is no longer considered a material weakness and provides the user with additional qualitative information to describe why the conclusion was reached. This allows for situations where a material weakness no longer exists due to changes in controls put in place by company management, or other situations where changes in operations or the business environment contributed to the resolution of the previously reported material weakness.

Material Weaknesses Based on Aggregation

Additionally, there may be circumstances in which a material weakness was reported in the prior year due to the aggregation of multiple deficiencies. We believe it might be misleading to permit an opinion that states a material weakness has been corrected in situations where only some of the original deficiencies were remediated. We suggest that this communication be addressed by requiring additional explanatory language in the opinion, as previously suggested.

Operational or Environmental Changes

In certain instances a material weakness will be resolved by the company based in part or entirely on changes in operations or the business environment. For example, a registrant may reduce certain operations for business reasons or may enter into a significant acquisition which results in the previously reported material weakness no longer being material. In these situations the material weakness was not corrected, but the control that did not previously function is no longer needed to meet the overall objective. We believe that our suggested opinion language allows for the auditor to report on this type of resolution of a material weakness, provided an appropriate description of the actions or circumstances contributing to the resolution are provided. We recommend that additional guidance be included in the proposed standard to clarify the auditor's responsibilities in these situations.

Combined Reporting

We expect registrants will frequently engage the auditor to report on resolution of a material weakness prior to filing their annual report on Form 10-K, to enable inclusion of the auditor's report on the resolution of the material weakness to also be included in the annual report. In this circumstance, we recommend that the auditor be permitted to combine the annual report on internal controls with the report on resolution of material weaknesses. We believe that a combined report will provide a clearer and more meaningful communication to users, and further encourage registrants to address identified material weaknesses in a timely manner.

BDO Seidman, LLP

330 Madison Avenue
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

PCAOB Question 2: 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 auditors' 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 auditors' report deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses had been eliminated?

Our view is that the failure to cite the existence of any remaining material weaknesses could be misleading to users. Accordingly, we recommend such a disclosure in the auditor's report or a reference in the auditor's report to an accompanying note. Whether such disclosures might deter companies from engaging the auditor to perform this work is likely to be based on facts and circumstances.

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

We believe it would be problematic in some cases for the auditor to attest to the remediation of a weakness that arose and was remediated within or between interim periods. For issues arising during the quarters, auditor responsibilities are generally limited to observation and inquiry procedures. Thus, the auditor often has only a limited basis for assessing the reasonableness of the company's interim disclosure, and the specific issues and circumstances surrounding the nature and extent of the material weakness that was reported. Moreover, since the auditor may not have obtained sufficient evidence for determining whether, in fact, the weakness that was remediated was a material weakness, any reporting on this matter needs to reflect this circumstance.

The requirements in this proposed standard for obtaining evidence of the design and operation of controls and for the auditor's test of the controls set a high standard for the performance of an engagement to report on the remediation of a material weakness. In our view, to attest to the remediation, the auditor may need considerable evidence concerning the nature of the weakness and controls design in place when the weakness was identified and reported to ensure that the weakness was fully and appropriately

BDO Seidman, LLP

330 Madison Avenue
New York, NY 10017-5001
Phone 212-885-8000
Fax 212-885-1299

analyzed. This may be difficult or impossible to do in situations where the auditor was not significantly involved at the time with management's identification of the material weakness. To expand, directly or indirectly, the auditor's involvement with interim issues will increase audit costs, and is potentially inconsistent with the focus of AS 2 -- the effectiveness of controls over financial reporting as of the period end date.

Since the company is not precluded from disclosing its view that the previously reported weakness was remediated, we believe that the market purpose for disclosure can be met without auditor attestation. However, if the Board concludes that such an attest engagement should be permitted, we believe that additional guidance is needed to address when this type of engagement would be appropriate and to expand the guidance with respect to the sufficiency of evidence needed to satisfy the requirements of the proposed standard.

Additional Comment - Documentation

Auditing Standard No. 2 paragraph 20.c. states that for the auditor to satisfactorily complete an audit of internal control over financial reporting, management must support its evaluation with sufficient evidence, *including documentation.* The proposed standard, however, in paragraph 7, states that the auditor may report on a company's elimination of a material weakness only if certain conditions are met, including item d. which requires that management support its assertion with sufficient evidence. There is no reference in the proposed standard to any documentation requirement by management to support its evaluation. Clarification is needed to explain why the documentation clause was omitted from management's responsibilities.

*****

We appreciate your consideration of our comments and suggestions and would be pleased to discuss these matters further with the PCAOB and its staff.

Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 or wkolins@bdo.com.

Very truly yours,

BDO Seidman, LLP

BDO Seidman, LLP

Jack Ehnes
Chief Executive Officer

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

California State Teachers'
Retirement System
7667 Folsom Boulevard
Post Office Box 15275
Sacramento, CA 95851-0275

916.229.3706 Tel
www.calstrs.com

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 and PCAOB Auditing Standard No. 2

Ladies and Gentlemen:

This letter is sent on behalf of the members of the California State Teachers' Retirement System (CalSTRS). CalSTRS is the third largest public pension system in the U.S., with over $125 billion in assets that are managed on behalf of 750,000 members and beneficiaries. Our domestic equity portfolio currently is comprised of $54 billion in investments; CalSTRS invests in over 2,800 stocks domestically. In terms of market value, the domestic equity portfolio represents the overwhelming majority of our trading on national securities exchanges. The long-term nature of CalSTRS' liabilities, and our responsibilities as a fiduciary to our members, has made us keenly interested in efforts to restore investor confidence in the capital markets and to improve transparency in financial reporting.

CalSTRS is pleased to provide comment on the Public Company Accounting Oversight Board's Release No. 2005-002, dated March 31, 2005, in which PCAOB proposed a new auditing standard relating to the elimination of a previously-disclosed material weakness in a reporting company's internal control over financial reporting.

In addition, we take this opportunity to comment upon lessons learned during the preparation of the first cycle of Annual Reports of Form 10-K of reporting companies that were subject to the internal control attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") and Item 308 of Regulation S-K under the Securities Act of 1933.

The Proposed Auditing Standard

We applaud the PCAOB for its prompt recognition of the need for the proposed auditing standard. We believe that in certain instances, disclosure by a reporting company of a material weakness in its internal control over financial reporting will create uncertainty in the eyes of investors, and volatility in the company's securities. Under the current regulatory structure, such a company would be required by Item 308(c) of Regulation S-K to provide quarterly updates as to remediation efforts to the extent these efforts constituted material changes in the company's internal control over financial reporting. However, the investing community would have to wait until the company's next Annual Report on Form 10-K for third-party verification (provided by the company's auditors) of the elimination of the material weakness. This could unnecessarily prolong market uncertainty as to the current quality of the company's internal controls.

CalSTRS therefore supports the adoption of the proposed auditing standard. We have the following two observations in response to PCAOB's specific requests for comments, and several additional thoughts that we believe may be helpful as PCAOB formulates the definitive standard.

Responses to Specific Requests for Comment

- <u>We believe that companies should not be permitted to engage auditors to attest to the elimination of some previously-disclosed material weaknesses without disclosing the continuing existence of other previously-disclosed material weaknesses.</u>

We believe that if a reporting company identified more than one material weakness in its most recent annual report on Form 10-K and the auditor is engaged to express an opinion on some but not all of the material weaknesses that were identified in that report, the auditor should be required to specifically identify the previously-disclosed material weaknesses that remain unremediated. We believe that this will provide the most meaningful disclosure to readers in that it will set forth, in one location, a full update of the status of the company's current status in its efforts to eliminate its material weaknesses. We do not believe that this requirement would pose an undue burden on issuers, nor should it provide a disincentive to the utilization of the audit authorized by the proposed standard.

- <u>Auditors should be permitted to comment in interim reports on the elimination of material weaknesses identified after the immediately preceding audit of the company's internal control over financial reporting.</u>

As proposed, the standard would not permit the reporting company to engage its auditors to report upon the elimination of a material weakness discovered after the filing of the company's most recent audited financial statements. We believe that this disclosure may be useful to investors and beneficial to reporting companies, and see no reason to prohibit such an engagement. Without this modification, issuers may conclude that the discovery is material and thus disclosure is required in a current report on Form 8-K or a Quarterly Report on Form 10-Q pursuant to Rule 12b-20 (which requires disclosure of material information that is not otherwise called for by a specific line item of a form), yet be unable to disclose in the same or a subsequent 10-Q the successful remediation of the material weakness, forcing investors to wait until the filing of the 10-K to learn of the elimination of this material weakness.

We believe that our preceding comment should also apply to this situation - if a reporting company elects to utilize the standard to disclose the elimination of a material weakness that was discovered after the completion of the most recent audit, the disclosure must also identify any other material weaknesses that have been identified since the date of the last audit and remain unremediated. If this requirement is not imposed, we believe that reporting companies would be able to selectively disclose the good news regarding post-audit material weaknesses while withholding disclosure regarding corresponding potentially less favorable news. We also believe that a reasonable investor, when presented with information regarding the elimination of post-audit material weaknesses, would conclude that no other post-audit material weaknesses exist, leading to undue volatility in the reporting company's securities when the remaining disclosure is made in the company's next 10-K.

Additional Observations Regarding the Proposed Standard

- We believe that PCAOB should retain the provisions of Paragraph 3 of the Auditing Standard to the effect that the promulgation of the Auditing Standard should not be read to imply that auditors should be retained in most or all instances to report in interim reports on the elimination of material weaknesses.

We agree with PCAOB that while the proposed standard can provide disclosure that will be very useful to the markets in certain situations, there is no need for reporting companies to engage their auditors pursuant to the proposed standard with respect to every elimination of a post-audit material weakness. We also believe that it is entirely appropriate for a reporting company to elect to engage its auditor to report on the elimination of some, but not, all, post-audit material weaknesses that have been eliminated, for example in situations where there is heightened concern as to the presence of a particular material weakness, and recommend that PCAOB explicitly so state in the final version of the Auditing Standard. Our interest in greater transparency in financial reporting is balanced by our desire that unnecessary costs not be imposed on reporting companies.

- Clarify that if the auditor is retained to provide an attestation under the Auditing Standard relating to a post-audit material weakness, then the reporting company should also be required to provide its evaluation of the elimination of that material weakness.

Item 308(c) of Regulation S-K currently requires reporting companies to disclose material changes in internal controls in the prior quarter. There is no requirement for the company to provide any evaluation of the effectiveness of these changes. Under the proposed auditing standard, the auditor will attest to the effectiveness of management's assertion that the material weakness has been eliminated. Paragraphs 40 and 55 of the proposed standard require the auditor to obtain written attestations from management on the elimination of the material weakness and the effectiveness of the internal control(s) that are the subject of the engagement. However, there is no requirement that management's attestation be publicly disclosed. We do not see a justification for this difference from the annual attestations of internal controls required under Item 308 of Regulation S-K, and believe that the investing public will be just as interested in disclosure of management's views in the case of auditor attestation relating to a post-audit material weakness. We therefore recommend that the SEC amend Item 308(c) of Regulation S-K to include a requirement that management must disclose their attestation to such elimination in any engagement of the auditor pursuant to the proposed standard.

- <u>Adjustments to AS No. 2 that are adopted in response to lessons learned during the 2004 10-K cycle for calendar year accelerated filers should also be included in the Auditing Standard relating to reports on elimination of material weaknesses.</u>

We discuss below certain suggestions for modification to PCAOB's Auditing Standard No. 2 in light of lessons learned from the first cycle of Annual Reports that were subject to the requirements of Section 404 of the Act. We strongly urge PCAOB to evaluate the proposed standard in light of comments received on AS No. 2.

Lessons Learned Regarding Section 404 from the 2004 Annual Report Cycle for Calendar-Year Accelerated Filers

CalSTRS believes that the enactment of the Sarbanes-Oxley Act of 2002 was an important milestone for investors. We agree that accurate and reliable financial reporting lies at the heart of our financial market system and that investor confidence in such information is fundamental to the health of our markets. However, despite these salutary intentions, it has been widely reported that the cost of implementing Section 404 of the Act, whether measured in actual dollar expenditures or in time and effort expended on the part of reporting companies and their advisors, has far exceeded expectations. We have participated in several forums on the implementation of Section 404 and have been struck by the number of market participants that believe the benefits of this statutory provision far outweigh its costs; still there is wide agreement that the implementation of this section is in need of remediation.

Our interest in best protecting the value of our assets by promoting improved governance and financial reporting practices must be balanced against the need for regulatory burdens to be roughly commensurate with the benefits afforded. We believe that the quality of internal control over financial reporting has deteriorated markedly in recent years, and as an institutional investor we are deeply concerned about the systemic risks posed by this decline. However, we do not believe it is in investors' best interests to require reporting companies to expend millions of dollars annually on analyses of internal controls that may be overly formulaic and ill-suited to actually preventing fraudulent activities or inadvertent but material error in the preparation of financial statements.

We commend PCAOB, and the Securities and Exchange Commission, for their willingness to consider ways to improve the implementation, and reduce the cost, of the internal control reporting requirement for public companies, and in particular for jointly hosting the roundtable that was held to discuss this topic on April 13, 2005. To that end, we would like to make the following suggestions for PCAOB and the SEC to consider as they formulate guidance in this area.

- The detail-oriented nature of the internal control disclosure process, and the sheer magnitude of the work required for the initial season, risks diverting management and the board from analyzing and addressing material issues facing their business.

In general, we are concerned that the detail-oriented application of the internal control disclosure requirements risk so monopolizing the time of senior management, the Audit Committee and the Board of Directors of reporting companies that they will not be capable of devoting the time and resources necessary for them to develop and maintain the deep understanding of the business and risks of their companies necessary to be able to anticipate and prevent fraudulent activity. We recognize that, to some extent, the quantity of resources required to complete the attestation process for 2004 can be viewed as a deferred cost reflecting inadequate investment in internal control in prior years. We also recognize that costs should fall as repetition of the process occurs. However, costs incurred in 2004 were at a sufficiently high level that even if these predictions prove to be true, there is still ample room to streamline the process and increase its efficiency without compromising its results.

- Auditors should be encouraged to utilize concepts of materiality and risk-based analysis in determining the scope of their testing of internal controls

Although the SEC's definition of internal control makes clear that the goal of this standard is to provide reasonable, not absolute, assurances, we believe that the initial experience under Section 404 suggests that auditors and regulators may have been seeking assurance that borders on the absolute. In particular, we are aware of auditors imposing absurdly high coverage ratios in their evaluations of the effectiveness of internal controls, in some instances requiring 80% or even 90% of all internal controls to be individually tested. To the extent that these efforts can be ascribed to allegedly overly detailed or prescriptive provisions of AS No. 2, we strongly urge PCAOB and the SEC to modify this standard so as to make clear that internal control audits need not verge from the concept of reasonable assurance. It is important that such guidance (or specific amendments to AS No. 2) be in place such that reporting companies and their auditors can rely on it during the 2005 audit.

- Reporting companies and their auditors should be encouraged to engage in free and open discussions regarding the preparation and audit of financial statements and the formulation of appropriate accounting treatments

We have heard from a large number of sources that reporting companies are now unwilling to seek guidance from their auditors on interpretive questions under GAAP, or to circulate early drafts of financial statements to their auditors, for fear that incorrect positions taken at early stages of analysis will lead to material weakness determinations. Conversely, we also understand that auditors' shy away from meaningful discussions with clients about interpretive positions under GAAP during the course of a fiscal year for fear that frank and open discussions may compromise the auditor's independence with respect to the reporting issuer under current SEC rules and interpretations. We submit that there is no benefit to the market or to investors by chilling wide ranging discussions between auditors and their reporting company clients and encourage that the PCAOB and the SEC so clarify.

- <u>The issues with the implementation of Section 404's internal control reporting requirements are disproportionately harsh on small companies.</u>

While the bulk of our investments are in companies that fall on the large cap end of the capitalization scale, we are also significant investors in small cap companies. Because these companies can provide very attractive investment opportunities for our members, it is important to us that appropriate companies be encouraged to enter the public capital markets in the United States. We believe that the impact of Section 404 on small companies has been disproportionately harsh, and may have served to deter companies from going public in the United States. We are aware of colloquial evidence suggesting that companies that might otherwise be suitable candidates for initial public offerings are refraining from pursuing this option because they (and their sponsors) are unwilling to bear the expense of Section 404 compliance. Because we believe that this is a negative development for our capital markets, we strongly encourage both PCAOB and the SEC to consider steps that may be taken to provide some degree of relief for small companies while preserving the beneficial aspects of Section 404.

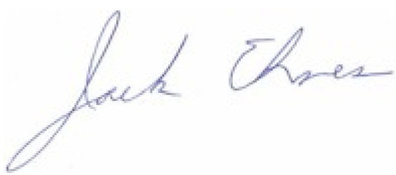
We understand that the Committee of Sponsoring Organizations is preparing a revised version of *Internal Control -- Integrated Framework* that is designed to apply to smaller companies. We support this development, and encourage PCAOB to provide guidance to the auditing profession so that this standard is appropriately utilized, along with greater exercise of judgment and risk-based analysis by auditors as discussed above, to ease the burdens imposed by Section 404 on smaller companies.

Further, since newly-public companies are required to comply with Section 404 in their first 10-K, we also understand that companies that are otherwise willing to pursue IPOs are in effect forced to time their transactions so as to become public early in their fiscal year, thus maximizing the available time to complete the work necessary to comply with Section 404. Given the volatility and unpredictability of the IPO markets in recent years, this sort of artificial timing constraint is counterproductive. As one means of addressing this issue, we suggest that PCAOB and the SEC consider permitting newly-public companies to delay Section 404 compliance until they file their second 10-K.

* * * * * * *

Thank you for the opportunity to comment on these important issues. If you would like to discuss this letter, please feel free to contact me at the number set forth above.

Sincerely,



Jack Ehnes
Chief Executive Officer

Center for
Public Company
AICPA Audit Firms
Committed to Audit Quality

American Institute of Certified Public Accountants • Harborside Financial Center, 201 Plaza Three • Jersey City, NJ 07311–3881
201.938.3030 • 888.817.3277 • fax 201.521.5436 • www.aicpa.org/cpcaf

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.

* * * * *

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.

<u>Disclosure of Controls Related to Eliminated Material Weakness</u>

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.

<u>Question 2</u>

(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.

* * * * *

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
Mr. Charles D. Niemeier, Member, PCAOB

RECEIVED
MAY 17 2005

COUNCIL OF
INSTITUTIONAL
INVESTORS

Suite 512 • 1730 Rhode Island Avenue, N.W. • Washington, D.C. 20036 • (202) 822-0800 • Fax (202) 822-0801

May 4, 2005

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 18

Dear Secretary:

The Council of Institutional Investors, an association of more than 140 corporate, public and union pension funds collectively holding more than $3 trillion in pension assets, is writing in support of the PCAOB's proposed Auditing Standard, "Reporting on the Elimination of a Material Weakness." The proposed standard addresses the need of investors to know whether previously reported material weaknesses in a company's internal controls have been corrected.

The Council believes that this standard is a reasonable response to an issue unaddressed by Auditing Standard 2 (AS 2), namely how a company might report on remediation efforts. Although companies have an obligation on a quarterly basis to report any material changes in their internal controls, including a remediation of previously disclosed material weaknesses, verification by an independent auditor of a remediation could benefit investors. Accordingly, the Council supports the PCAOB's proposal to give companies the ability on a voluntary basis to seek an auditor's opinion that one or more material weaknesses have been corrected and to provide auditors with a standard for giving such as opinion.

The proposed rule is drafted to minimize costs, for example by emphasizing that auditors may rely on the work of others. And, it is appropriate that the proposed standard requires the auditor's opinion to identify explicitly the material weakness in question and the limit of the auditor's conclusion with respect to the effectiveness of other controls.

Please contact me with any questions.

Sincerely,

Ann Yerger
Ann Yerger
Executive Director

Crowe

Crowe Chizek and Company LLC
Member Horwath International

330 East Jefferson Boulevard
Post Office Box 7
South Bend, Indiana 46624-0007
Tel 574.232.3992
Fax 574.236.8692
www.crowechizek.com

May 16, 2005

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Regarding: PCAOB Rulemaking Docket Matter No. 018

We are pleased to comment on a proposed Auditing Standard, "Reporting on the Elimination of a Material Weakness." Our comments follow the paragraph numbers in the proposal.

1. Paragraph 11. We suggest providing examples of how the "other components" of internal control over financial reporting, such as monitoring and risk assessment, can be expressed in terms of control objectives that relate to "a relevant financial statement assertion". It seems that the connection between the other components relate at best in an indirect fashion to a given financial statement assertion such as completeness for a financial statement line item. To avoid creating audit work that may not be intended, resulting in additional cost for registrants, the Board should provide guidance in the standard on how to express those "other components" in terms of specific control objectives over financial statement assertions.

2. Paragraph 23. Here, and elsewhere, the engagement of a successor to report on elimination of a material weakness is referred to as the "initial engagement". We suggest clarifying this term. The successor auditor may view the "initial engagement" to be the engagement to perform the integrated audit of the financial statements and internal control as well as to review quarterly information. Some reviews of quarterly information may have already been performed. Hence, the engagement of a successor to report on elimination of material weakness may not be the "initial engagement."

3. Paragraph 23c. While it may often be useful for the successor auditor to communicate with the predecessor about the basis for the predecessor's determination that a material weakness existed, we question whether it will be cost-effective to require this in all circumstances. The successor auditor needs to perform sufficient procedures, as specified in paragraph 23 and elsewhere, to obtain knowledge of relevant internal controls, and presumably the predecessor will have read the description of material weakness provided in the predecessor auditor's report. We question the need to perform the procedures that will be required to inquire of the predecessor and obtain an understanding of the predecessor's basis, when presumably the predecessor's report will indicate the material

weakness with suitable specificity as will management's report and documentation as to the elimination of the material weakness, and these latter two sources should be sufficient.

4. Paragraph 37. Under paragraph 185 of Auditing Standard No. 2, a principal auditor may refer to a report of another auditor as a basis for the principal auditor's opinions. Management and the principal auditor would each report on a material weakness, even if the material weakness was present in a subsidiary audited by another auditor. Presumably the subsidiary auditor would have performed audit procedures regarding the material weakness at the subsidiary they audited. We believe it will significantly add to the cost of an engagement regarding elimination of a material weakness if paragraph 37 of the current standard prohibits the principal auditor from referring to a report of another auditor as a basis for the principal auditor's opinion about the elimination of a material weakness. Paragraph 37 should be revised to permit the same division of responsibility as contained in paragraph 185 of Auditing Standard No. 2.

If paragraph 37 is not changed, it will require the principal auditor, in assuming full responsibility, to audit at least part of the entity that was previously audited by another firm. This cannot be efficient or cost-effective.

5. Paragraph 40f. This paragraph requires the auditor, in reporting on the elimination of a material weakness, to obtain a management representation letter that lists all material fraud and all fraud involving management. This does not seem efficient or cost-effective. We suggest that it is not necessary, in the limited focus of the audit of the elimination of a specified material weakness, to obtain representations unrelated to the specific material weakness that is the focus of the engagement.

If paragraph 40f is not changed, the standard should give guidance as to what the auditor is expected to do with a representation that describes a nonmaterial fraud that is not relevant to the specified material weakness. What procedures does the Board think should be done, and documented, regarding these additional representations, and are those procedures worth the cost involved in performing them? If the procedures are perfunctory ("read the representation") then what is the benefit of performing them or the assurance provided by the procedures?

6. Paragraph 47(l). The requirement in paragraph 47(l) to state that "the engagement includes obtaining an understanding of internal control over financial reporting" is very likely to require additional audit work that would not be cost-effective. The limited nature of a report on elimination of a material weakness should not require the auditor, <u>as part of the engagement performed on the elimination of the material weakness,</u> to obtain an understanding of internal control over financial reporting. Such an understanding would have to be performed and documented as part of the current engagement under Auditing Standard No. 3's documentation requirements, to allow an experienced auditor, with no other connection to the audit, to understand what was performed in obtaining the

understanding of the very broad area of "internal control over financial reporting" as part of "the engagement" regarding elimination of a material weakness.

Presumably the auditor obtained such an understanding of internal control over financial reporting in the prior engagement to audit and report on internal control, in which the material weakness was identified and disclosed. However, the wording proposed is that as part of the (current) engagement, the auditor obtained such an understanding, not that the auditor obtained the understanding as part of the prior engagement that was performed. We suggest this wording be removed or that it be changed to refer to an understanding obtained in a prior engagement, so as to not require obtaining the understanding as part of the current engagement. The situation where a new auditor is reporting on the elimination of a material weakness would properly require including the language about obtaining an understanding of internal control over financial reporting since a new auditor would have to obtain this understanding.

The fourth paragraph of the example report under A-1 in Appendix 1 also requires the same change to avoid excessive audit work. The statement in the example auditor's report about obtaining an understanding is not limited to "internal controls over financial reporting relevant to the material weakness". Instead, it states that the auditor obtained "an understanding about internal control over financial reporting" as part of "our engagement" involving elimination of a material weakness. Auditing Standard No. 2 requires 41 paragraphs (paragraphs 47 through 87) to explain what is involved in "obtaining an understanding of internal control over financial reporting" and we submit that it is not cost-effective to those 41 paragraphs of procedures (company-level procedures, major classes, walkthroughs, etc.) to be performed (or to be stated that they were performed) in a limited engagement.

We suggest limiting the understanding required and reported to "an understanding of internal controls relevant to the control objective for which a material weakness was reported."

7. Paragraph 47(o). We believe that the second bullet in paragraph 47(o) refers to an inappropriate date. If not revised, this may lead to require audit work which we do not believe would be cost-effective. The second bullet indicates that the auditor is to state that the auditor has not applied auditing procedures as to the effectiveness of controls "as of any date after <u>the date of</u> management's annual assessment…". If management's assessment of controls "as of" a year-end of December 31, 2005 is completed on and is itself dated February 28, 2006, the proposed wording would thus state that the auditor has not applied auditing procedures as to the effectiveness of controls "as of any date after February 28, 2006", which is the date management finished its assessment of its controls as of December 31, 2005.

This does not agree with the report provided by the auditor under Auditing Standard No. 2, in which there is no reference to the "date of" management's annual assessment but which instead refers to management's assessment of controls "as of" year-end. Under Auditing Standard No 2, the auditor does not indicate they have done any procedures regarding controls through the date of completion of management's assessment of the status of year-end controls. The proposed language is subject to a different inference, that in fact something more may have been done about controls in existence at February 28, 2006, although nothing has been done about controls in existence after that date except for the material weakness that has been eliminated. This potential meaning may lead a reader to erroneously conclude that the auditor previously expressed some assurance about internal controls as of the date of completion of management's assessment, which may lead an auditor to perform some testing of controls as of the date management's annual assessment is completed. In other words, if the auditor says they didn't do anything about control effectiveness after a certain date, shouldn't that infer they did something as of that date and shouldn't users expect something to have been done?

We suggest removing references to "the date of management's annual assessment" and indicating clarifying that the relevant date beyond which "as of" controls were not tested is the year-end date.

8. The "note" appended to paragraph 47(o) may be useful in the auditor's report whether there is a successor auditor or not. The auditor, in auditing the assertion as to the elimination of a material weakness, is not reaching conclusions about the effectiveness of any controls of the company other than the controls specifically identified. This should be stated in the auditor's report, regardless of whether a successor auditor is used or not.

9. Paragraph 50c. The reference to "a significant subsequent event" is too broad a reference and will lead to audit work not necessary to the scope of a limited engagement to report on elimination of a material weakness. Assume a company obtained revised debt financing or settled a lawsuit. These subsequent events may have no relevance or association to the particular material weakness that has been eliminated. Why should the auditor modify the standard report if a significant subsequent event exists regardless of its relevance to the elimination material weakness?

10. We suggest that the Board address what may well become a common practice. This proposed standard allows a subsequent engagement that discusses the elimination of a material weakness after year-end. Assume the year-end is December 31, 2005, management completes its assessment as of February 20, 2006, and the auditor completes its integrated audit on March 8, 2006. Assume management's assessment, or the auditor's feedback to management prior to the completion of the integrated audit, indicates there is a material weakness "as of" December 31, 2005. Management takes immediate action to eliminate the material weakness, and as of March 4, 2006, prior to filing the form 10-K and reports on internal control, the material weakness has been eliminated. Management now requests the optional engagement as specified in this proposal. In this circumstance, what is the desired reporting? In the Form 10-K, management's assessment and the auditor's report will indicate that there is a material weakness "as of" December 31, 2005. May there also be an

auditor's report included in the Form 10-K that states the auditor, in a separate engagement regarding elimination of a material weakness, is of the opinion that the material weakness "as of" December 31, 2005 has been eliminated through the subsequent improvements made by management by March 4, 2006? Can the initial Form 10-K filing include two auditor reports—one that there is a material weakness as of year-end, and the second that the material weakness has been subsequently eliminated? Will this be confusing to users or helpful? Obviously filing the report on elimination of a material weakness should not precede filing of the report disclosing the material weakness, but may these be made concurrently in the initial Form 10-K? We make no recommendation other than that guidance would be appreciated so that practice can evolve as the Board desires. We do note that if the Board believes the initial Form 10-K should not have both the integrated audit report plus the report on elimination of a material weakness, there will be additional filing and subsequent event investigation audit costs will be required for the amended Form 10-K or Form 8-K that will subsequently be required.

If you have any questions, please contact Jim Brown.

Very truly yours,

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Deloitte.

Deloitte & Touche LLP
10 Westport Road
PO Box 820
Wilton, CT 06897-0820

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 on Reporting on the Elimination of a Material Weakness

Deloitte & Touche LLP ("Deloitte") is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB") on its Proposed Auditing Standard on Reporting on the Elimination of a Material Weakness, PCAOB Rulemaking Docket Matter No. 018 (the "release," or the "proposed standard") (March 31, 2005). This letter is submitted on behalf of Deloitte & Touche LLP, the non-U.S. Member Firms of Deloitte Touche Tohmatsu, and Deloitte Touche Tohmatsu.

We are strongly supportive of the following elements of the proposed standard, which we believe contribute to its effectiveness:

- Very specific conditions for engagement acceptance, including that management must support its assertion with sufficient evidence (documentation) and present a written report that will accompany the auditor's report *(paragraph 7).*

- The requirement that only the current or successor auditor are permitted to perform this engagement, and that the successor auditor must obtain sufficient knowledge of the company's business and its internal control over financial reporting to address the objective of the engagement *(paragraphs 2, 23, 24).*

- The requirement that the auditor must directly obtain the principal evidence for the opinion on each material weakness and stated control objective identified in management's assertion *(paragraphs 34 and 35).*

We do, however, have comments on the proposed standard which we believe will improve its application. Our letter is organized into the following sections:

I. Overall Comments
II. Responses to Questions Posed by the PCAOB
III. Comments on Specific Paragraphs
IV. Editorial Comments

I. OVERALL COMMENTS

Title of the Proposed Standard / Reporting–-Achieving the Control Objective
As currently titled and written, the proposed standard provides guidance on reporting on the *elimination* of a *material weakness,* in an attempt to provide the public with reliable information on significant improvements in internal control. However, technically, the proposed standard would allow a company to "downgrade" a material weakness to the level of a significant deficiency, but be able to report that the material weakness had been "eliminated." We are concerned that use of terminology such as "elimination" or "eliminated" would not be in the best interest of the public, as the resulting report may mislead users into believing that there are no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness, even though one or more significant deficiencies may still exist.

We strongly believe that a more appropriate structure for the proposed standard would be for the company to report that the *control objective(s)* related to the material weakness *has been achieved,* and for the auditor to provide assurance on that assertion.

In our other comments to the illustrative report example, we have provided specific suggestions on how to revise the report to reflect this recommendation.

Proposed Standard's Relationship with Auditor's Responsibility Regarding Quarterly Disclosures
We are concerned that the current language in the release to the proposed standard may create confusion about the auditor's responsibilities with respect to management's quarterly disclosures of material changes in internal control, particularly when such disclosures include remediation of a material weakness. The proposed standard was not intended to include guidance as to procedures the auditor generally performs during the quarterly reviews; accordingly, to avoid any potential confusion, we recommend that the PCAOB compare and contrast (1) the limited procedures to be performed during a quarterly review with respect to management's quarterly disclosures of material changes in internal control (as described in PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" ("PCAOB AS 2")) with (2) procedures to be performed on management's assertion during an engagement described by the proposed standard.

We recommend that the proposed standard or release language specifically state that, with respect to quarterly disclosures about material changes in internal control, the auditor does not have a responsibility to "audit" such disclosures that management includes in its quarterly filings, but only has a responsibility to perform the limited procedures described in PCAOB AS 2 and report if the auditor is aware that the disclosures require material modification in order to be accurate and to comply with the requirements of Section 302 of the Sarbanes Oxley Act of 2002.

Guidance from the SEC

We believe that registrants will need guidance as to the form of management's assertion and the mechanism for inclusion of management's assertion and the related auditor's report in the Form 10-Q or Form 8-K. For example, it would not be appropriate for management to assert in its report that "internal control is effective" because a material weakness has been remediated. In order to make such a statement, it would be necessary for management to test and evaluate the entire internal control over financial reporting, not simply the controls related to the area with the material weakness.

Although we are aware that this concern is not relevant to the PCAOB's standard setting process because such guidance does not belong in an auditing standard, we nevertheless have concerns that lack of specific guidance in this area will lead to confusion, frustration, and diversity in practice. We plan on including a recommendation for additional guidance for registrants in our comment letter to the Securities and Exchange Commission ("SEC") during the SEC comment period for the proposed standard.

II. RESPONSES TO QUESTIONS POSED BY THE PCAOB

Question 1:

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

- If not, how might it communicate more clearly to report users?

The sample auditor's report included in the proposed standard does not clearly describe the results of the engagement for the reasons cited below. To begin with, the form of report is inconsistent with other interim standards with respect to (1) the description of the report on the audit of the annual assessment (e.g., see AU 552 and AU 623), (2) references to design and operating effectiveness (e.g., see AU 324), and (3) the basis for the opinion (i.e., that "the control objective is met").

Proposed revisions to make such description consistent (see marked revisions to the introductory paragraph in the report below) further highlight the lack of clarity around the engagement in the proposed standard, particularly for a situation in which the auditor is engaged to audit the remediation of only some of the material weaknesses identified. We believe that readers may inadvertently infer that the report has addressed all material weaknesses previously reported as of the company's year end, or identified during an interim period.

In addition, we do not believe that the form of opinion is appropriate. Rather, we believe that the auditor should be reporting (1) more consistently with AU 324 and (2) similarly to PCAOB AS 2, in which the auditor expresses an opinion on management's assertion, as illustrated below.

Paragraph 47g states that the report must include an identification of the specific controls that management asserts remediate the material weakness. The illustration of the report, however, infers that only the newly-implemented controls would be described. We believe that, in many circumstances, it would be more appropriate for both management and the auditor to acknowledge that the newly-implemented controls, together with other existing controls, achieve the control objective. Accordingly, we recommend that, as part of this type of engagement, the auditor test those controls which are directly relevant to achieving the specific control objective (not simply the newly-implemented or revised controls), and that all of these controls be listed in the auditor's report.

The standard inherent limitations paragraph does not seem appropriate without specific tailoring for the subject matter of this report, which covers only one or a limited number of control objectives rather than the broader subject of internal control over financial reporting. Accordingly, such paragraph should be revised for the specific subject matter of this report.

Our recommendations for specific revisions to the illustrative report are as follows (throughout this letter, additions are shown in bold underline and deletions in double strike-through):

Report of Independent Registered Public Accounting Firm

> We have previously audited**, in accordance with standards of the Public Company Accounting Oversight Board (United States),** ~~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,* f*or example,* "*criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*~~.~~"], **and have issued** ~~. O~~**o**ur report, dated [*date of report*], **which report expressed an adverse opinion because of the existence of a material weakness(es).** ~~identified t~~**T**he following material weakness**(es)** in the Company's internal control over financial reporting **was (one of the material weaknesses) identified in our report**:

[*Describe material weakness(es)*]

The existence of the material weakness(es) noted above resulted in XYZ Company failing to achieve the following control objective(s) at December 31, 200X:

[*Describe the related control objective(s) that has not been achieved because of the existence of the material weakness(es)*]

We have applied auditing procedures to management's assertion, included in the accompanying [*title of management's report*], that **they have tested the control(s) identified below and concluded that the control(s) was suitably designed and operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objective(s) identified above, related to the material weakness(es) in internal control over financial reporting identified above, was achieved at [*date of management's assertion*]**~~management has eliminated the material weakness in internal control over financial reporting identified above by implementing the following control(s)~~**. Management has asserted that the relevant control(s) in place and operating at [*date of management's assertion*] is as follows**:

[*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 **management's assertion and on the achievement of the control objective(s) identified above** ~~the elimination of the material weakness~~ based on our auditing procedures.

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 **C**~~c~~ompany has **achieved the control objective(s)** ~~eliminated a previously reported material weakness~~ **related to a previously reported material weakness(es)**. Our engagement included obtaining an understanding of internal control ~~over financial reporting~~**relating to the above control objective(s)**, 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, **management's assertion that the control objective(s)** ~~XYZ Company has eliminated the material weakness~~ described above **was achieved** as of [*date of management's assertion*] **is fairly stated in all material respects**~~because the stated control objective is met as of [date of management's assertion]~~. **Further, in our opinion, the control(s) described above was operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objective(s) described above was achieved at [*date of management's assertion*].**

We were not engaged to and did not conduct an audit of **XYZ Company's** 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 **the Company's** 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 **other** controls of the **C**~~c~~ompany as of any date **or for any period** ~~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~~ **as of [*date of management's assertion*]**.

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

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

Question 2:

- 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 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?

As discussed above, in order to prevent users from mistakenly believing that management's assertion and the related auditor's report address all material weaknesses, we believe that it is necessary to identify that there are other material weaknesses not addressed in either management's assertion or the related auditors' report. The language that we propose above would not make it necessary to specifically cite what the other material weaknesses were; however, a paragraph such as the following could be added for further clarity:

> Management's assertion does not address the other material weaknesses that were reported as of December 31, 200X relating to [*describe nature of such material weaknesses*]; nor were we engaged to apply auditing procedures to such areas as of or for any date or period subsequent to December 31, 200X. Accordingly, we express no opinion, or any other form of assurance, on whether such material weaknesses are still in existence or whether the control objectives related to the material weaknesses have been achieved.

Whether such language deters companies from engaging the auditor to perform work on the remediation of some but not all material weaknesses will depend on a variety of factors. If an excluded material weakness related to a control objective that is only relevant to year-end financial reporting, such language should not be a deterrent. If the excluded material weakness relates to a more significant area than the one that the company has asserted has been remediated, it might rightfully serve as a deterrent. If a third party is driving the request, the third party may not be interested in any material weaknesses other than in a specific area that affects their relationship with the company, and such language should not, therefore, be a deterrent, assuming that management's assertion and the auditor's report addresses the material weakness in which the third party is interested.

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?

We do not object to allowing reporting on a material weakness identified and remediated as of an interim date. However, if the proposed standard was to allow this, it should provide specific guidance as to the appropriate form of reporting. For example, the reference to the report issued relating to the prior annual evaluation would not be relevant if such report expressed an opinion that internal control was effective at such date. Additionally, the report would need to reference whatever statements management previously made when reporting the material weakness to the public (e.g., the disclosures in the company's Form 10-Q). Also, if the auditor is reporting on fewer than all of the material weaknesses previously reported as of the company's year end, or identified during an interim period, the report should specifically state that the material weaknesses being reported on is one of others identified, so that the reader is alerted to the fact that other material weaknesses may continue to exist.

III. COMMENTS ON SPECIFIC PARAGRAPHS

We have the following other substantial comments on the proposed standard:

Paragraph 5--Selection by management of any date for their assertion
Many of the material weaknesses identified during the most recent annual reporting period related to the control environment or controls relating to the financial closing process. Accordingly, we recommend that these engagements only be performed as of quarterly dates for U.S. issuers, instead of at any date during the year. This requirement would also provide the auditor with the added benefit of being able to consider the results of interim review procedures (AU 722) when rendering a report under this proposed standard, as well as provide a link between the auditor's report and management's quarterly disclosure of material changes in internal control. However, as foreign filers do not report quarterly, special guidance would be needed as to how this guidance would be applied to foreign filers. For example, the PCAOB may consider stating that these engagements can be performed for foreign filers as of a date that corresponds with issuing press releases on interim financial information that are filed with the SEC.

Paragraph 24–-Not able to obtain a sufficient basis
This paragraph states that in certain circumstances (based on the nature of the company and the pervasiveness of the specific material weakness), the successor auditor may determine that he or she is not able to obtain a sufficient basis for performing this type of engagement without performing a complete audit of internal control over financial reporting. We strongly support this concept, however, we believe that this statement also holds true for the current auditor. Accordingly, we recommend that a similar statement be explicitly included in the proposed standard, related to the *current* auditor.

Paragraph 26–-Operating effectiveness
The note to paragraph 6 states that if the auditor does not test the operating effectiveness of a specified control, then the auditor would not be able to obtain reasonable assurance for the purpose of expressing an opinion on this type of engagement. As management and auditors may not be able to test the operating effectiveness of newly-designed, infrequent, non-recurring controls until the applicable event or transaction recurs (e.g., controls relating to the appropriate accounting for an acquisition), we recommend that the proposed standard

specifically state in paragraph 26 that there may be certain material weaknesses for which this type of engagement cannot be performed, unless the applicable controls operated before or as of the date stated in management's assertion.

Paragraph 31--Guidance on performing substantive procedures
This paragraph simply states that the auditor *may determine* that performing substantive procedures to support recorded financial statement amounts affected by the identified controls is necessary to obtain sufficient evidence regarding the operating effectiveness of controls. Given that many material weaknesses are identified through the detection of material misstatements as a result of substantive procedures, we strongly recommend that additional guidance be included in the proposed standard to clarify how and when substantive procedures would be performed during this type of engagement. It would be very helpful to provide examples of situations where it would be necessary to perform substantive procedures in conjunction with testing of design and operating effectiveness of the applicable controls (e.g., deficiencies in control activities relating to the processing of transactions).

Paragraph 35--Using the work of others
As the scope of this type of engagement will be very narrow in focus, using the work of others will occur in only limited circumstances. We recommend expanding such thoughts in paragraph 35, as follows:

> 35. …Because the scope of an engagement to report on the elimination of a material weakness is more narrowly focused that 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. **<u>Accordingly, the auditor will be able to use the work of others in only limited circumstances.</u>** Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

Paragraphs 33, 35 and 36–-Requirement to perform walkthroughs when using the work of others
Paragraph 33, in the requirement that "the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2," omits the reference to paragraph 116, which relates to the requirement for the auditor to perform walkthroughs. Paragraph 35 then includes a requirement for the auditor to perform walkthroughs himself or herself, which raises the question as to whether the requirement in paragraph 35 differs from the requirement in paragraph 116, and if so, how? We recommend that paragraph 33 include a reference to paragraph 116 and that the last sentence of paragraph 35 be deleted.

Paragraph 36 then provides an illustration of how to apply this section. The second paragraph of the illustration states that "The auditor ***might*** perform a walkthrough of the reconciliation process himself or herself" [emphasis added]. This sounds inconsistent with the requirement to perform a walkthrough him/herself. To clarify the example and to avoid potential confusion that walkthroughs are not required when using the work of others, we recommend the following revisions to paragraph 36:

> 36. …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. **<u>For example,</u>** ~~T~~**<u>t</u>**he auditor ~~might~~ perform**<u>s</u>** a walkthrough of the reconciliation process himself or herself; perform**<u>s</u>** testing at a limited number of locations himself or herself; test**<u>s</u>** the work of others performed at a limited number of other locations; review**<u>s</u>** the results of the work of others at all other locations tested; and determine**<u>s</u>** that, qualitatively and quantitatively, principal evidence had been obtained. …

We also recommend using a different, more helpful example in paragraph 36 to illustrate how the auditor may use the work of others in this type of engagement. We believe that the bank reconciliation example is too simplistic and not realistic, especially given the nature of the material weaknesses disclosed to date. We recommend that the PCAOB consider including an example related to controls over accounting for leases, taxes, or other areas where registrants have disclosed the existence of material weaknesses.

Paragraph 37–-Dividing responsibility

While dividing responsibility may not be workable in certain situations, we believe that the proposed standard should not prohibit it. For example, a material weakness might relate to activities that are performed at numerous subsidiaries. If the auditor of a significant subsidiary applied auditing procedures to management's assertion regarding the remediation of the material weakness at one subsidiary and issued a report thereon, it would seem reasonable that the principal auditor might divide responsibility with respect to the portion of the material weakness remediated at that particular subsidiary. We would agree that responsibility could not be divided if the auditor of the subsidiary did not issue such a report.

Paragraphs 39, 41 and 51--Scope limitations

The proposed standard contains very circular cross-references within paragraphs 39, 41 and 51 regarding the effect of scope limitations on the engagement. We recommend that paragraph 39 contain all the guidance regarding the auditor's actions when faced with a scope limitation and that paragraphs 41 and 51 refer back to paragraph 39. Accordingly, we recommend (1) deleting the reference in paragraph 39 to paragraph 51, (2) replacing the reference to paragraph 51 in paragraph 41 with a reference to paragraph 39, and (3) deleting the last sentence of paragraph 51.

Paragraph 47–-Reference to the predecessor auditor's report

We believe that the phrase in the note to paragraph 47b, "or, if necessary, to the predecessor auditor's report," is unclear. It would certainly be necessary to reference a predecessor auditor's report, including identification of the material weaknesses, when there are more than one material weakness and the successor auditor is engaged to apply auditing procedures to fewer than all previously reported materially weaknesses. But in what situations would it *not* be "necessary"? It might be inappropriate to reference the predecessor auditor's report if the material weakness arose subsequent to such report or if the successor auditor believed that such report was erroneous. However, in the latter case, the successor auditor would probably conclude that he or she should not accept the engagement to apply audit procedures or that he or she should resign from the engagement. Accordingly, we recommend that, in successor auditor situations, the auditor's report on the remediation of a material weakness should explicitly refer to the predecessor auditor's report unless the material weakness arose in an interim period. As discussed above, specific reporting guidance is necessary if the auditor is permitted to apply auditing procedures to a material weakness that arose in an interim period.

Paragraph 49–-Modifications to the report when reporting on more than one material weakness

Paragraph 49 states that the report elements in paragraph 47 should be modified if the auditor reports on the remediation of more than one material weakness but provides no guidance with respect to specific modifications. We recommend that specific guidance be provided or that the paragraph be deleted.

Paragraph 53–-Adverse reports

While we agree with and strongly support the requirement for the auditor to communicate in writing to the audit committee if he or she does not believe the material weakness has been eliminated, we believe that the proposed standard should require the issuance of an adverse report. This adverse report does not need to be made available to the public, but it is appropriate for the auditor to formally document and report his or her conclusions when a conclusion has, in fact, been reached.

IV. EDITORIAL COMMENTS

In addition to the more substantial comments noted above, we also have editorial comments, as described below.

Paragraph 22

Rather than carving out a procedure in paragraph 23 that would not be performed, we recommend that the note to paragraph 22 refer only to the specific steps that would be performed, as follows:

> 22. …the auditor should follow the requirements for a successor auditor in paragraphs 23**a-b** and 24~~, except paragraph 23c~~.

Paragraph 25

In the first sentence of paragraph 25, we recommend that further clarification be made to the phrase "are designed and operated effectively," such as the following:

> 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 **suitably** designed and operated effectively **for a suitable period of time**, that these controls achieve the company's stated control objective(s)…

Paragraph 45
We believe that paragraph 45d should refer to "management's assertion" (singular) not "management's assertions."

Appendix 2
We believe that the reference to "AICPA *Professional Standards*, vol. 1" in footnote 15 should be to the PCAOB Interim Standards.

We appreciate the opportunity to comment, and would be pleased to discuss these matters with you further. If you have any questions or would like to discuss these matters further, please contact Robert J. Kueppers at (203) 761-3579 or John A. Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Jr., Member
Charles D. Niemeier, Member

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting
J. M. Tull School of Accounting
The University of Georgia
Athens, GA 30602-6252
706 542-3502

April 1, 2005

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 2006-2803

PCAOB Rulemaking Docket Matter No. 018

Gentlemen:

I have read the Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness – and I support its issuance as a final standard. This is an issue that has come up in my own experience as a corporate board member and I believe it is appropriate for a company to be allowed to have its assertion that a material weakness in internal controls has been eliminated endorsed by its auditor. I also strongly support making this a voluntary service. Given what many believe is already excessive cost involved in the Sarbanes-Oxley Section 404 exercise, companies should not be required to incur extra costs for "elimination services" at an interim date.

Page 4 of the Proposal states that an auditor would not be permitted to report on the elimination of a material weakness that arose in the current year (did not exist at the end of the last reporting year). As far as I can tell, the only way that this is addressed in the actual proposed standard is through the Note on page A1-3 that says, "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." Perhaps I am missing something, but that seems like an awfully subtle way of communicating what apparently is an important point, given your request for specific comments on this matter. So one suggestion would be to make the scope of the standard clearer.

More importantly, I really don't see a need for this limitation and urge that it be dropped. At a minimum, you should explain why such a limitation is necessary. In neither the introductory part of the Proposal nor the draft standard is any reasoning given for the position you have taken. Given that a company will have to publicly report both the occurrence of a new material weakness and its subsequent elimination in a later quarter (if that happens), I see no reason why the company shouldn't be allowed to seek its auditor's concurrence with the elimination if it wants. Again, I wouldn't require such an engagement, but I can't think of why it should be precluded.

As a further point, there is very little "basis for conclusions" included in the Proposal. I suggest that you consider providing your reasoning in the PCAOB's documents as much as possible. Knowing why something is being required helps interested parties understand the purpose of new rules and allows those parties to provide more informed comments on proposals. I recognize that the PCAOB has done a reasonably good job of explaining in final rules what comments were received and why or why not those comments were reflected in the final rules. However, given that all of the development of the standards is "behind closed doors" and not subject to significant public observation or even knowledge, those interested in your standards seek to understand more of the thinking that caused the PCAOB to reach the tentative positions that you did. I think you owe this to those who wish to follow your efforts and help you make the final products as good as possible.

Thank you for considering these comments and please let me know if you have any questions.

Sincerely,

Dennis R. Beresford

From: Jo-Ann Pierce [jo-ann.pierce@enpria.com]

Sent: Monday, May 16, 2005 8:17 PM

To: Comments

Cc: Victoria Whitlock

10260 SW Greenburg Roa
Suite 85
Portland, OR 972
Phone **(503) 293-84**
Fax (503) 293-84

5400 Carillon Point
Bldg 5000, 4th Floor
Kirkland, WA 98033
Phone **(425) 576-4004**
Fax (425) 823-3869

May 16, 2005

Mr. J. Gordon Seymour, Acting Secretary
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 2006-2803

Email: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 018
PROPOSED AUDITING STANDARD – REPORTING ON THE ELIMINATION OF A MATERIAL WEAKNESS

Dear Board Members:

Thank you for the opportunity to comment on this important subject.

Disclosure of a material weakness in internal controls has the potential to have a significant negative impact on a company in many significant ways, e.g. driving down a company's stock price or affecting its eligibility to compete for contracts. Because the magnitude of a material weakness could be potentially significant, Enpria feels that if a company eliminates a material weakness within the year before the annual report period, the company should be able to obtain an independent attestation that the material weakness has been corrected. Of course, this should be voluntary and would be left up to the company to determine if the additional expense of an interim attestation is warranted.

We would recommend a word change from ‘eliminated’ to ‘has completed remediation and no longer has that specific material weakness’.

We would also like to see a range of examples added to the final decision to provide a better basis for subjective measurement. In particular we would like to request what you feel to be a spectrum of standard to non standard reporting items.

We respectfully submit the following input in the form of answers to your specified questions:

1. 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?
Yes.

2a. If the auditor does not express an opinion on all material weaknesses 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?
Yes.

Note: We feel it should be clear which material weakness is being opined on; reference should be given to the annual report or management comment letter where it originated.

2b. Would such a requirement provide helpful information to report users or would it detract from 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)?

We feel it would provide helpful information. As in most reporting, it is largely a matter of clear writing and presentation technique.

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?

No. It seems the purpose of this standard is specifically designed toward material weaknesses that require being called out in the annual report; this type of engagement is not designed toward interim issues that are resolved.

Finally, Enpria feels this is a good step forward in allowing companies to decide what is best for them and yet protect the interest of the investing public. In working with our clients from small business to large fortune 100 companies we have come to believe strongly that “one size does NOT fit all”, and that each management team should be granted the flexibility to run their businesses as they see fit. We use this criteria to draw the boundary line between public safety and unnecessary intrusion.

Once again, thank you for your time and effort and the opportunity to comment on this important subject.

Sincerely,

Victoria Whitlock, Compliance Practice Manager
With support from J Michael Hayes, Compliance Analyst

ERNST & YOUNG

Ernst & Young LLP
1300 Huntington Building
925 Euclid Avenue
Cleveland, Ohio 44115

Phone: (216) 861-5000
www.ey.com

May 16, 2005

Mr. J. Gordon Seymour
Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 018
Proposed Auditing Standard—Reporting on the Elimination of a Material Weakness

Dear Mr. Seymour:

We are pleased to comment on the PCAOB's proposed auditing standard (the "Proposed Standard") related to the reporting on the elimination of a previously disclosed material weakness in internal control over financial reporting.

The Proposed Standard would provide a mechanism for issuers that have identified and reported one or more material weaknesses in their internal control over financial reporting to inform investors and others, with the added assurance, where possible, of the company's independent auditor, that the material weaknesses have been eliminated. We recognize that issuers, investors and other capital market participants may desire and benefit from timely, positive assurance from independent auditors on the elimination of such material weaknesses rather than having to wait until the following year's 404 reports for such assurance.

As a general matter, we have concerns regarding an auditor's issuance of interim reports on narrow aspects of a company's overall internal control over financial reporting. Because internal control is dynamic and changes over time, there is the possibility that, at the same time that a previously identified material weakness is eliminated, other controls might no longer be operating effectively. We have significant reservations regarding the possibility of misinterpretations and the potential for expanding (rather than narrowing) the "expectation gap" if auditors provide reports with positive assurance at interim dates when an integrated audit has not been performed. Accordingly, we would prefer not to issue these reports. In addition, if such reports are to be issued, we would prefer an alternative model whereby we would provide negative assurance on the elimination of a material weakness in a manner similar to the negative assurance provided on issuers' quarterly financial information filed with the SEC.

ERNST & YOUNG

Notwithstanding these reservations, considering our profession's unique role in the capital markets and our ability to provide a beneficial service to issuers, investors, and others, we understand the need for the Proposed Standard and, with certain recommended changes, support its issuance. Our concerns regarding the proposed reporting model can be mitigated through appropriate communication and disclosures by issuers and auditors, provided there is clear recognition by all capital market participants of the targeted scope of such reports.

We believe the guidance in the Proposed Standard generally serves the needs of issuers, investors, and auditors by establishing appropriate engagement acceptance, performance and reporting guidance, and we commend the Board for its timely development of the proposal. However, we believe the guidance could be improved in certain respects as described below. We have organized our comment letter to respond to the three specific issues on which the Board seeks public comment as identified in the Release in Item IX, *Opportunity for Public Comment*, and then to provide additional comments that do not relate to these particular issues.

Specific Issues on which the Board Seeks Comment

1. 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?

   We are in general agreement with the example auditor's report. We believe the overall approach of requiring management to issue an acceptable assertion as a condition for engagement performance, requiring the auditor to state in the report that the auditor examined management's assertion, and require an opinion on the subject matter (but not management's assertion) will clearly communicate to users. We recognize that this differs from the reporting model in Auditing Standard 2 in which the auditor's annual report includes an opinion on management's assessment, but the elective nature of this engagement and the requirement for an acceptable assertion supports the form of report proposed.

   However, we believe the auditor's report elements should specifically require the auditor to state that the auditor examined (or audited) management's assertion. Paragraph 47d requires the auditor to identify management's assertion that it has eliminated the identified material weakness in internal control over financial reporting, and the illustrative report states that the auditor "applied auditing procedures" to management's assertion. For consistency, we believe the illustrative report also should be revised to state that the auditor examined (or audited) management's assertion (rather than stating that the auditor applied auditing procedures.)

ERNST & YOUNG

Additionally, we believe the standard should require management to specify a date as of which the material weakness has been eliminated, rather than requiring the auditor to opine that the material weakness has been eliminated as of the date "of" management's assertion. We believe this approach is supported by the fact that there currently is no requirement for management to date the management report containing the assessment of internal control over financial reporting (and many management reports issued and filed have not been dated), but under Auditing Standard 2 there is a clear requirement for management to indicate an "as of" reporting date—the measurement date as of which management made its assessment. Similarly, we believe management should be required to assert that the material weakness has been eliminated as of a specific reporting date, and the auditor should similarly opine on the elimination of the material weakness as of this date. Finally, there should be clarifying language that would indicate this need not be the first date as of which the material weakness was eliminated, but only a measurement date for purposes of the assertion and audit.

We also note that the proposed opinion 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]."* We believe it is unnecessary and inappropriate to include the phrase "because the stated control objective is met as of…" because (1) the report otherwise describes the controls implemented and the related control objectives, and (2) there are other factors the auditor considers in reaching the opinion. Accordingly, we suggest deleting this phrase from the opinion.

We also have a concern regarding the lack of a reference in the opinion to materiality. The material weakness being eliminated previously was identified as part of an integrated audit of the financial statements and internal control over financial reporting, and the determination that the control deficiency constituted a material weakness included consideration of materiality as required by Auditing Standard 2. We believe that a conclusion as to the elimination of a material weakness also requires consideration of materiality, and that the auditor's opinion should inform the reader that it is being given with respect to internal control over financial reporting. The Proposed Standard should be revised to address how the auditor considers materiality in performing this engagement, and should specifically state that materiality is considered as of the date of management's assertion that the control has been eliminated.

Accordingly, in summary, we believe the example opinion should be revised in the following manner: "In our opinion, XYZ Company has eliminated the material weakness with respect to the company's internal control over financial reporting as described above as of [date specified in management's assertion], in all material respects." We also recommend corresponding changes to the reporting elements in paragraph 47.

2. 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?

   If more than one material weakness was identified in the previously issued auditor's report and management has eliminated some but not all of those material weaknesses, we believe management should disclose in its assertion, and the auditor should disclose in the auditor's report, that the previously issued reports described additional material weaknesses that were not included in the scope of the engagement, and accordingly, the auditor is not opining on whether any material weaknesses other than those specifically described in the report have or have not been eliminated. Additionally, management and the auditor should refer the reader to the previously issued annual report for additional information on those material weaknesses.

   We believe that the Proposed Standard appropriately emphasizes clear communication to users of the report of the scope of the engagement, including a clear communication that the auditor is not opining on the elimination of all material weaknesses if some material weaknesses have not yet been eliminated or if the auditor is unable to obtain sufficient evidence to conclude that they have been eliminated. We agree with this emphasis, even if this reporting requirement deters some companies from engaging the auditor to perform this work in such situations. The Proposed Standard appropriately permits reporting by the auditor on the elimination of some but not all material weaknesses if companies so choose to engage their auditors, and appropriately requires in such situations clear communication of the existence of previously reported material weaknesses not covered by the auditor's report – the clarity of such communications is important to investors and other users of the reports.

ERNST & YOUNG

We do not believe the report need identify each material weakness that was not covered, but it should identify the fact that not all previously reported material weaknesses are included in the scope of the examination. Management could provide additional disclosures to the reader in management's assertion regarding the material weaknesses that were not included in the scope of management's assertion and the auditor's report.

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

   No. We do not believe the Board should provide for reporting on the elimination of a material weakness that was identified by the Company at an interim date and also eliminated as of an interim date. First, we do not believe there will be significant demand or need for such a service. The driving force behind the Proposed Standard is the *annual* issuance of the Section 404 report on internal control over financial reporting with no reporting mechanism for communicating until a year later when the next Section 404 report is issued. In the case of an interim identification of a material weakness, that time period is, by definition, much shorter.

   Additionally, in such cases, the material weakness would most likely have arisen as a result of a material change that occurred since the Company's prior annual report. Until the next full management assessment and integrated audit is performed, we do not believe the auditor will have considered the interaction and potential implications of the change resulting in the material weakness and the change eliminating the material weakness to other controls and processes. Accordingly, until the next integrated audit is performed, we do not believe the auditor, in most cases, would have the knowledge of the current state of internal control to be able to evaluate the changes that have occurred and whether the newly identified material weakness has truly been eliminated.

   Finally, we believe a report on the elimination of a material weakness that was never identified as a material weakness in the prior Section 404 report could be very confusing to investors. At a minimum, such a report would need to include disclosure not only of the material weakness, but also of the changes that occurred subsequent to the previously issued 404 report that created the material weakness and the changes that eliminated the material weakness.

ERNST & YOUNG

Other Comments

1. We note in Section VIII, *Conforming Amendments*, of the Release that if the Board adopts, and the SEC approves, the Proposed Standard, the Board's interim standards would be amended to preclude the auditor 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. If the Proposed Standard as finalized retains the provision of positive assurance, we would agree that a conforming amendment would be appropriate to preclude a *review level attestation* engagement when the subject matter is the elimination of a material weakness. However, there could be appropriate uses for an *agreed-upon procedures* engagement in which the subject matter is the elimination of a material weakness and in which the report is restricted to specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes, and accordingly, we do not believe the Board should preclude such engagements from being performed. As a practical matter, we also point out that because such reports would be restricted to the specified parties, they would not be made generally available to investors, and thus such engagements would not be a substitute for the engagements addressed in the Proposed Standard. However, there might be situations where engaging the independent auditor to perform agreed-upon procedures for the restricted use of specified parties would be useful.

2. We note Sections II-VI of the Release contain information that is helpful in understanding the meaning and implications of requirements in the Proposed Standard. We believe the final standard should include this material (e.g., in an appendix or other section describing the Board's basis for conclusions) to facilitate understanding and consistent application of the final standard.

3. We believe the issuance of the Proposed Standard will result in questions regarding (a) the procedures management should perform to provide a basis for management's Section 302 disclosures in situations where a material weakness has been reported in the previous annual auditor report on internal control over financial reporting, and (b) the procedures the auditor should perform when management makes such a disclosure. For example, management may identify a material weakness at its assessment date, and subsequently remediate that material weakness and communicate the material changes that were part of the remediation in its quarterly 302 disclosures. The Proposed Standard would establish a requirement, with respect to a management assertion for this engagement, for management to evaluate the effectiveness of the controls that eliminate the material weakness and to support its assertion that the material weakness has been eliminated with sufficient evidence. This raises the question regarding whether management has the same responsibility to evaluate the controls with sufficient evidence if it states in its quarterly disclosures and certifications that its disclosure controls and procedures that

ERNST & YOUNG

were previously ineffective because of a material weakness are now effective. It also raises the question regarding whether the auditor has a responsibility to determine if management has evidence to support such a disclosure as part of the auditor's SAS 100 procedures. We believe the Board (and the SEC) should clarify that the guidance pertaining to an engagement performed in accordance with the Proposed Standard does not otherwise extend to either management's disclosures or the auditor's SAS 100 procedures.

4. We recognize and agree with the focus on control objectives (or "what could go wrong" questions) in the Proposed Standard, and the importance of determining whether controls are suitably designed and operating effectively to achieve those objectives. We believe COSO and Auditing Standard 2 include the concepts of control objectives, but do not explicitly require documentation of control objectives. We believe the Board should consider explicitly stating that documentation of control objectives is required.

5. Auditing Standard 2 (paragraphs B18-B29) and PCAOB Staff Question and Answer 24-26 and 28 address situations in which a company uses a service organization. The inability to obtain a SAS 70 report or other evidence of the effective operation of controls at a service organization may result in a material weakness and adverse opinion on internal control over financial reporting. We believe a Company that has such a material weakness may conclude that the subsequent receipt of a SAS 70 report would eliminate such a material weakness. However, we can foresee a number of questions and issues regarding whether such a report is sufficient for the Company to assert and the auditor to opine that the material weakness has been eliminated, including whether the time period covered by the tests of controls described in the SAS 70 report needs to include the current as-of date that the material weakness has been eliminated or the prior assessment date, or both, or neither (e.g., the report covers a portion of the prior year but does not include the Company's assessment date.) We believe the Proposed Standard should be revised to address how the auditor should consider the time period covered by a SAS 70 report in determining whether such a report provides evidence that a material weakness has been eliminated. The Proposed Standard also should be revised to address other factors that management and the auditor should consider in determining whether a SAS 70 report truly eliminates the material weakness, including the effect of any user control considerations identified in the SAS 70 report.

6. Auditing Standard 2 includes guidance (paragraphs 198-199) on the auditor's responsibilities with respect to an auditor's report on management's assessment of internal control over financial reporting included in filings under the Federal securities statutes. We believe the SEC should clarify the filing requirements, if any, for an auditor's report on the elimination of a material weakness and the Proposed Standard

ERNST & YOUNG

should address any additional auditor's responsibilities with respect to such reports that are filed.

****

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP

FLORIDA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

325 WEST COLLEGE AVENUE• P.O. BOX 5437• TALLAHASSEE, FLORIDA 32314
TELEPHONE (850) 224-2727• FAX (850) 222-8190

May 4, 2005

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness (PCAOB Rulemaking Docket Matter No. 018)

The Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (the Committee) has reviewed and discussed the above referenced "proposed auditing standard." The Committee has the following comments:

First, the Committee feels that the sample auditor's report included in the proposed standard does clearly describe the results of the engagement.

Second, the Committee does not believe the proposed standard should require the auditor's report to specifically identify any other additional material weakness identified during the most recent audit of internal control, but which have not been corrected. The Committee feels such additional information would detract from the reporting on the material weakness, which had been corrected. In addition, since the material weaknesses have already been reported on as part of the most recent audit of internal control, there is no need to report on the uncorrected material weaknesses again.

Lastly, the standard should not allow a report on the elimination of a material weakness, in which the material weakness was identified and eliminated by management as of an interim date. The reporting requirements under Section 404, as well as this proposed standard appear to be sufficient to describe material weaknesses identified and if applicable, corrected.

The Committee appreciates this opportunity to share our views and concerns. Members of the Committee are available to discuss any questions you may have regarding this communication.

Very truly yours,

Kathryn M. Means, CPA, Chairman
FICPA Accounting Principles and Auditing Standards Committee

Committee members coordinating this response:
Lillian Conrad
Randy Dillingham

G A O
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

May 9, 2005

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: *PCAOB Rulemaking Docket Matter No. 018: Proposed Auditing Standard—Reporting on the Elimination of a Material Weakness*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) March 31, 2005, proposed auditing standard on reporting on the elimination of a material weakness.

Overall, GAO supports the proposed standard. We especially agree with provisions of the proposed standard that:

- explicitly state that auditors cannot obtain reasonable assurance sufficient to support an opinion if the auditors evaluate control design without also evaluating the effectiveness of those controls in operations (noted throughout the proposed standard);
- establish required conditions for performing such an engagement (paragraphs 7-8); and
- establish requirements for successor auditors, thus minimizing the opportunity for management "opinion shopping" (paragraph 23-24).

Detailed below are our views on the questions posed by the Board on page 12, part IX of the release that accompanied the proposed standard. The attachment to this letter includes our suggested revisions to the illustrative report in Appendix A of the standard.

<u>PCAOB Questions 1:</u> *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?*

<u>GAO Response:</u> We believe that the report language can be clarified and made more consistent with PCAOB Auditing Standard No. 2 by

- specifying that the auditors were engaged to express opinions on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness,

- requiring auditors to opine on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness,
- requiring auditors to indicate if more than one material weakness was identified in the auditor's original report on internal control over financial reporting,
- notifying readers where they can obtain the auditor's original report or indicating that a copy of the auditor's original report is attached, and
- clarifying that the auditor is not reporting that any other material weaknesses were corrected.

We have incorporated these recommendations in our suggested revisions to the illustrative report that are attached to this letter

<u>*PCAOB Questions 2:*</u> *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?

<u>GAO Response:</u> We believe that, in order to avoid confusion, an auditor's report on elimination of a material weakness should refer to the auditor's original report on internal control over financial reporting and disclose that the auditor's original report identified other material weaknesses. The auditor could attach a copy of the auditor's original report or disclose where the reader can obtain the auditor's original report. This would allow readers to consider the importance of the material weakness that was eliminated in relation to other material weaknesses, thus providing valuable context for the reader. Facilitating access to the auditor's original report should not deter companies from initiating such engagements.

Additional language would also be needed in the report on elimination of a material weakness to specify that the auditor was not engaged to perform procedures related to any other material weaknesses included in the auditor's original report and therefore, the auditor is not reporting on the other material weaknesses or on the overall effectiveness of internal control over financial reporting.

We have incorporated these recommendations in our suggested revisions to the illustrative report that are attached to this letter

<u>PCAOB Questions 3:</u> 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)?

<u>GAO Response:</u> The proposed standard states that in an engagement to report on the elimination of a material weakness, auditors <u>must</u>

- obtain sufficient competent evidence about the design and operating effectiveness of controls that provide reasonable assurance that the company's stated control objective has been achieved (paragraph 15),
- obtain an understanding of and evaluate management's evidence supporting its assertions that 1) the specified controls related to the material weakness are designed and operated effectively, 2) these controls achieve the company's stated control objectives(s) consistent with the control criteria, and 3) the identified material weakness has been eliminated (paragraph 25), and
- perform tests of controls over a period of time 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.

We believe it would be extremely difficult to satisfy these requirements in an engagement to report on the elimination of a material weakness that was identified and eliminated during an interim period. However, if auditors are able to satisfy these requirements, the standard should allow them to report on the elimination of a material weakness that was identified and eliminated during an interim period. The PCAOB should caution auditors that when performing an engagement to report on the elimination of a material weakness that was identified and eliminated during an interim period, the auditors should assure that they can obtain sufficient evidence to satisfy the requirements noted above.

We thank you for considering our comments on this very important issue.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

cc: The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

Our suggested changes to the illustrative report in Appendix A of the proposed standard are as follows:

> 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).*"]. A copy of our report can be obtained at [identify location or website where the report can be obtained, or state that a copy of the report is attached]. Our report, dated [*date of report*], identified ~~the following~~ material weaknesses in the Company's internal control over financial reporting, one of which was the following:
>
> [*Describe material weakness]*
>
> ~~We have applied auditing procedures to management's assertion, included i~~ In the accompanying [title of management's report], ~~that~~ management asserted that it 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.~~
>
> We were engaged to express an opinion on whether 1) management's assertion is fairly stated, and 2) management has eliminated the material weakness. 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, obtaining and evaluating evidence about whether controls identified in management's assertion as eliminating the material weakness were designed and operated effectively and satisfy the entity's control objective, ~~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, management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated. Also 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. We also were not engaged to determine whether any other material weaknesses were corrected. ~~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 internal control over financial reporting ~~any other controls~~ operated effectively after December 31, 200X or that any other material weaknesses were corrected.

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*]

Grant Thornton LLP
The US Member Firm of
Grant Thornton International

175 West Jackson
Chicago, Il 60604
312 602-8000

Grant Thornton

May 16, 2005

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

Via e-mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 018, *Reporting on the Elimination of a Material Weakness*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the proposed auditing standard, *Reporting on the Elimination of a Material Weakness*. We understand the Public Company Accounting Oversight Board's ("Board" or "PCAOB") desire to respond to those in the public markets who desire an update to the internal control audit results when material weaknesses are disclosed, but we have serious concerns about the misperception and improper conclusions such users may place on an engagement to report on the elimination of material weaknesses as set forth in this proposed standard. Further, we have concerns that this proposed standard could actually undermine Auditing Standard No. 2. These concerns with respect to the proposal are expressed below and in Appendix A, which contains our responses to the questions put forward by the Board. Additional paragraph-level comments are presented in Appendix B.

Objective of the Engagement

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 (paragraph 4). To obtain reasonable assurance, the auditor should obtain and evaluate evidence about whether specified controls were designed and operating effectively as of the date specified by management and whether those controls satisfy the company's stated control objective (paragraph 6). The auditor's opinion is on whether the identified material weakness was eliminated as of the date of management's assertion because the stated control objective is met as of the date of management's assertion (paragraph 47n).

We do not believe that the nature and extent of the evidence to be obtained, as specified in paragraph 6, will be sufficient to meet the objective as stated in paragraph 4 and, as a result, it would not support the opinion described in paragraph 47n.

According to the briefing paper, the proposed standard anticipates that the auditor's testing would be limited to the controls specifically identified by management as eliminating the material weakness. This concept is reiterated throughout the proposed standard (beginning with paragraph 6). However, many controls address more than one control objective, and many control objectives are addressed by more than one control (either overlapping or complimentary). Given the nature of internal controls, it would be inappropriate for the auditor to assume that all controls that were previously implemented and reported on as operating effectively are still operating effectively. Unless the auditor conducts an audit of all significant and relevant controls designed to address a specified control objective, we believe that it would be inappropriate to state that a material weakness has been eliminated. We believe that the wording of the objective in the proposed standard would imply to the users of the auditor's report a broader scope of assurance than is intended.

We believe that the objective in the proposed engagement should be to express an opinion on management's assertion that specified controls designed to meet the specified control objectives have been implemented and that they are operating effectively. The auditor's opinion should reflect this objective and state that, if other controls not tested in this examination still operate effectively, the result would be that the material weakness is eliminated.

The Integrated Audit

We understand and appreciate the reason why Auditing Standard No. 2 requires an integrated audit of the financial statements and internal control over financial reporting: each audit provides the auditor with information relevant to the auditor's evaluation of the results of the other audit. In fact, our experience in the most recent audit season showed that most material weaknesses in internal control were identified by performing substantive audit procedures. Given this premise, we have some concerns about the auditor reporting on eliminating a material weakness as a stand-alone engagement, even when the auditor has performed the integrated audit within the past year. We believe these concerns might be alleviated if the proposed standard strongly encouraged the auditor to perform substantive audit procedures in connection with this proposed engagement. The option to perform substantive procedures is provided for in paragraph 31 of the proposed standard; however, given the value of substantive audit procedures in identifying material weaknesses, we believe that paragraph 31 should be strengthened by requiring the auditor to consider performing such procedures.

We agree with paragraph 30 of the proposed standard, which acknowledges that it would take longer for the auditor to obtain sufficient evidence as to the operating effectiveness of pervasive, company-level controls than of transaction-based controls. In fact, we believe that it would be very difficult and costly for the auditor who is not performing an integrated audit, to obtain evidence of operating effectiveness of a pervasive control in a timely manner to make reporting on remediation meaningful. For example, if the material weaknesses were related to the lack of effectiveness of the audit committee, it may not be appropriate for the auditor to report on the operating effectiveness of that control without doing an integrated audit. On the other hand, information technology general controls and process or transaction-level controls are very conducive to testing.

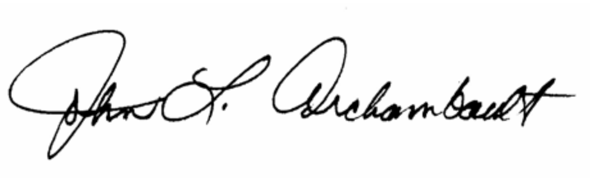
We believe that the proposed standard should be very clear as to the differences between these types of controls, including the different approaches that the auditor would have to take to test them. We further believe that the standard should emphasize, in the case where the auditor has been asked to report on operating effectiveness of a pervasive, or company-level control, the need to consider: (a) whether the auditor will be able to obtain sufficient understanding of the control; (b) whether the auditor will be able to obtain sufficient evidence regarding the operating effectiveness of the control; and (c) whether the control has been in operation for an adequate period of time in order for the auditor to determine the operating effectiveness of the control. We believe auditors should apply the same criteria for determining operating effectiveness of controls in this proposed engagement as they would for determining operating effectiveness in an integrated audit performed under Auditing Standard No. 2.

The auditor who has not performed the integrated audit within the past year is even a step further away from understanding the full picture, as anticipated by Auditing Standard No. 2. If the proposed standard does not have substantial additional clarity with respect to the necessary requirements to conduct to conduct an engagement of this nature, we question whether it is in the public interest for a newly-engaged auditor, who has not performed the integrated audit within the past year, to perform the proposed engagement as described in paragraphs 2 and 23. Therefore, similar to our recommendations related to the auditor who has been asked to report on the operating effectiveness of a pervasive, or company-level control, we believe that the standard should emphasize, in the case where a newly-appointed auditor has been asked to report on the operating effectiveness of a control, the need to consider: (a) whether the auditor will be able to obtain sufficient understanding of the control; (b) whether the auditor will be able to obtain sufficient evidence regarding the operating effectiveness of the control; and (c) whether the control has been in operation for an adequate period of time in order for the auditor to determine the operating effectiveness of the control.

* * * *

We would be pleased to discuss any of our comments with you. If you have any questions, please contact Mr.. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,



Grant Thornton LLP

Appendix A – Responses to Questions

Questions Regarding Reporting on the Elimination of a Material Weakness

1. **Does the sample auditor's report (included in the proposed standard) clearly describe the results of the engagement? If not, how might it communicate more clearly to report users?**

   We believe that there is potential for considerable confusion in the market place regarding this proposed engagement. It is imperative that the auditor's report be very clear. We have concerns regarding the following aspects of the sample auditor's report:

   - The sample report includes an 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. As noted in our cover letter, we believe that the scope of the engagement described in paragraph 6 would not provide the auditor with the assurance necessary to form such an opinion. We believe that the auditor should express an opinion on management's assertion that specified controls designed to meet the specified control objectives have been implemented and that they are operating effectively. The opinion should state further that, if other controls not tested in this examination still operate effectively, the result would be that the material weakness is eliminated.

   - The sample report includes a statement that the engagement includes obtaining an understanding of internal control over financial reporting. As noted in our comments on paragraph 47l, in Appendix B, we question whether such a statement would be misleading to the users of the auditor's report. In fact, this engagement only contemplates obtaining an understanding of the specified controls and relying on previously obtained understanding over other controls. Controls that have previously been implemented and reported on as operating effectively may not be operating effectively at the time this proposed engagement is performed.

2. **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, should the proposed standard require the auditor's report to specifically identify the additional material weaknesses?**

   We believe that, in the case where the auditor is not asked to report on all of the material weaknesses that were identified during the company's most recent audit of internal control, the proposed standard should require management to identify and the auditor to disclaim an opinion on the material weaknesses that are not addressed in the proposed engagement. The auditor's report should also disclaim an opinion on whether any other material weaknesses have developed.

   a. **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)?**

      We believe that a requirement for management to identify and for the auditor to disclaim an opinion on those material weaknesses that were identified during the company's most recent audit of internal control, but are not being addressed by the proposed engagement would be helpful to report users. The disclaimer of opinion would clarify that the auditor does not know if those material weaknesses still exist or if any other material weaknesses have developed. We are most concerned about the user who sees only a "clean" report on the elimination of a selected material weakness and believes that all material weaknesses have been eliminated.

b. 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?

Specific identification of other material weaknesses not addressed by the auditor's report may, indeed, deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses were eliminated. While we understand that accurate information is in the best interest of the public, we also believe that complete information is also in the best interest of the public. To disconnect the "good" information from the "bad" information allows the company to "cherry pick" which material weaknesses it would like to eliminate, and may result in piecemeal opinions, which are confusing to readers and not in the public interest.

3. Should this standard allow an auditor to report on the elimination of a material weakness when such weakness was identified and eliminated as of an interim date (in other words, identified and eliminated without ever being addressed in the company's Section 404 reporting)?

If the description of the material weakness is adequately described in both management's and the auditor's reports, and the nature, timing and extent of the procedures that the auditor performs support his or her ability to express an opinion (see our comments on paragraph 6), there is no reason why the auditor should not be permitted to report on the elimination of a material weakness when such a weakness was identified as of an interim date and eliminated as of a subsequent date. This information may be beneficial to the audit committee or others who are responsible for corporate governance at the entity. We would, however, recommend reminding the auditor that the guidance in paragraph 30 of the proposed standard regarding the period of time needed to determine the operating effectiveness of a control applies.

Appendix B – Specific Paragraph-Level Comments

The following describes additional concerns and offers other substantive comments and/or suggestions relating to specific paragraphs.

- **Paragraph 2** – In our opinion, it would be very difficult and costly for an auditor to obtain the requisite basis for performing the proposed engagement without having performed an audit of the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2 within the past year. By allowing for this possibility as early as paragraph 2 in the proposed standard, there is an implication that this situation is ordinary. Please see our recommendations related to the newly-appointed auditor in our cover letter.

- **Paragraph 9 –** We agree that the definitions of the terms as defined in paragraph 9 should carry the same definitions as in Auditing Standard No. 2; however, it is also important to emphasize that internal control over the preparation of interim financial information may differ from internal control over the preparation of annual financial statements because certain accounting principles and practices used for interim financial information may differ from those used for the preparation of annual financial statements, for example, the use of estimated income tax rates for the preparation of interim financial information, which is prescribed by Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*.

- **Section on "Applying the Standards of the PCAOB" –** These are fundamental thoughts. We wonder if they might be better placed at the beginning of the document – even as early as just after the "Applicability of the Standard" section.

- **Paragraph 20** – The concept of materiality becomes difficult as this engagement is disconnected from the audit of the financial statements. Paragraph 23 of Auditing Standard No. 2 specifically ties together the concepts of materiality related to financial reporting and internal control over financial reporting. If the auditor is not simultaneously conducting the audit of financial statements, do the same concepts of materiality apply? We suggest that the proposed standard include further guidance on the concept of materiality as related to reporting on the elimination of a material weakness in internal control. We suggest that materiality should be that of the most recent audited financial statements.

- **Paragraph 23 –** In our comments on paragraph 2, we recommended additional guidance when a successor auditor is performing the proposed engagement as his or her initial engagement. We also have recommended additional guidance when any auditor is reporting on the operating effectiveness of a company-level control as described in paragraph 23a.

  In our comments on paragraph 6, we noted that the proposed engagement contemplates that the auditor will obtain reasonable assurance by obtaining and evaluating evidence about whether specified controls were designed and operating effectively, and whether those controls satisfy the company's stated objective. Paragraph 23a requires a newly appointed auditor to follow the guidance in paragraphs 47 through 51 of Auditing Standard No. 2, in order to report on the elimination of a material weakness. We note that these procedures go far beyond the scope of the proposed engagement, as described in paragraph 6. We believe that the objective of the engagement, the scope of the work described in paragraph 6, and the level of evidence and understanding necessary to achieve the objective of the engagement are not aligned.

- **Paragraph 37 –** We find paragraph 37 to be very confusing. Is the intent of this paragraph to allow the principal auditor to make reference, but disallow the division of responsibility on this proposed engagement? To us, the logic seems backwards. When the principal auditor relies on the work of an other auditor, the principal auditor should make reference to the work of the other auditor. If there is no reliance on another auditor's work, there is no need to make reference. Furthermore, it is not clear if the principal auditor discussed in this paragraph is the principal auditor of the annual integrated audit, or the principal auditor of this proposed engagement, or both.

- **Paragraph 47l –** We question whether the statement that the engagement includes obtaining an understanding of internal control over financial reporting would be misleading to the users of the auditor's report. In fact, this engagement only contemplates obtaining an understanding of the specified controls, and relying on previously obtained understanding over other controls. As previously stated in our cover letter, controls that have previously been implemented and reported on as operating effectively may not be operating effectively at the time this proposed engagement is performed.

- **Paragraph 54 –** We question what the auditor's reporting and communication responsibilities would be if, in reporting on the operating effectiveness of specified controls, the auditor becomes aware of other material weaknesses that were not disclosed previously. We believe that management should be required to disclose all material weaknesses, whether previously disclosed or not, and the auditor should disclaim an opinion on all material weaknesses not being addressed by the proposed engagement. We request additional guidance on this topic.

7915 Xavier Court
Dallas, Texas 75218-4513

May 12, 2005

Public Company Accounting Oversight Board Via email to comments@pcaobus.org
Office of the Secretary
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket No. 018 - Comment letter on Proposed Auditing Standard *Reporting on the Elimination of a Material Weakness*

I am writing to express my opinions regarding the above referenced Proposed Auditing Standard. I support the ability of the auditor to report on the elimination of a material weakness.

- The scope and applicability of the Standard discussed in paragraphs 1 -3 should be amended to clarify whether the auditor may conduct an engagement to report on the elimination of a material weakness only if such material weakness has previously been reported on by the auditor in accordance with Auditing Standard No. 2, or whether the auditor may also report on the elimination of a material weakness not previously reported on by the auditor but which was disclosed by the company at an interim date. Conceptually, the auditor should be permitted to report on the elimination of all material weaknesses, including those not previously reported on by the auditor in accordance with Auditing Standard No. 2 but which were disclosed and subsequently remediated by the company at interim dates, and the Standard should be clarified accordingly.
- Situations may arise in which a material weakness is determined to exist as of the company's year-end, which material weakness would be disclosed for the first time and reported on by the auditor in accordance with Auditing Standard No. 2 when the company's Annual Report on Form 10-K is filed with the SEC. Prior to the filing of such Form 10-K, the company may be able to remediate the material weakness, and the auditor may have sufficient time to conduct procedures in order to be able to report on the elimination of such material weakness. In such situations, the auditor should be permitted to concurrently report on both (i) the material weakness as of the company's year-end and (ii) the subsequent elimination of the material weakness, and the Standard should be modified accordingly.

Thank you for your consideration of these comments and suggestions.

Sincerely,

Greg Swalwell

Greg Swalwell

HSBC

Douglas J Flint
Group Finance Director

12 May 2005

Ms Laura Phillips
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street
NW Washington
DC 20006-2803

Dear Ms Phillips,

PCAOB Rulemaking Docket Matter No. 018

We welcome the opportunity to respond to the Proposed Auditing Standard on Reporting the Elimination of a Material Weakness.

We note that the proposals are in effect a permission to engage audit firms to provide opinions on the correction of a material weakness and are not compulsory. We would be very concerned if there were to be any compulsion to obtain such opinions as we consider that based on Sarbanes-Oxley documentation experience, the work the auditors would deem necessary from their liability perspective would be totally disproportionate to the value to be derived by shareholders from the independent opinion on rectification.

We acknowledge, however, that in certain circumstances where material weaknesses have been identified and disclosed, the measures outlined in the proposed standard may be helpful in providing an increase in investor confidence resulting from the additional audit assurance provided, and therefore we support this proposal.

Yours sincerely,

HSBC Holdings plc
Level 41, 8 Canada Square, London E14 5HQ
Tel: 020-7991 2882 Fax: 020-7992 4872
Web: www.hsbc.com

Registered in England number 617987. Registered Office: 8 Canada Square, London E14 5HQ.
Authorised and regulated by the Financial Services Authority.

Intel Corporation
2200 Mission College Blvd.
Santa Clara, CA 95052-8119
Tel: 408-765-8080
Fax: 408-765-8871

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

Members and Staff of the Public Company Accounting Oversight Board (the "Board"):

Thank you for the opportunity to comment on the Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness* (the "Proposed Standard"). We appreciate the Board's flexibility in providing for elective engagements to report on the correction of material weaknesses; however, we are concerned such engagements will, in practice, become de facto required audit services.

Despite cautionary advice to audit committees to carefully weigh the costs and benefits of such engagements, [1] the simple availability of this option will likely lead to compulsory reporting over time. In the current environment of benchmarking against other companies and the pursuit of best practices, audit committees will be pressured into these elective engagements. The voluntary nature of the Proposed Standard is illusory.

In our view, such engagements would add costs without corresponding benefit to investors. Under Section 302 of the Sarbanes-Oxley Act, management must evaluate the effectiveness of disclosure controls and procedures and disclose "any change . . . that has materially affected, or is reasonably likely to materially affect . . . internal control over financial reporting."[2] Thus, disclosure of the continued existence or correction of material weaknesses would most likely be addressed through the Section 302 certifications. As an added measure of assurance, auditors must perform certain quarterly procedures to determine whether management should make any

[1] *See, e.g.,* PCAOB Board Member Daniel L. Goelzer, Statement at the Public Meeting of the Board (Mar. 31, 2005), *available at* http://www.fei.org/files/spacer.cfm?file_id=1517.
[2] Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release Nos. 33-8238, 34-47986, IC-26068, 68 Fed. Reg. 36646 (June 18, 2003).

disclosure modifications to comply with Section 302.[3] Finally, enhanced criminal penalties offer further incentive for transparent management reporting.[4]

In closing, we would encourage the Board to reconsider the Proposed Standard in light of current investor protections. Existing Section 302 certification requirements are sufficient, and this proposal will likely only add costs for shareholders.

Thank you for consideration of our views. Please do not hesitate to contact me at (503) 696-7931 if you would like any further information in connection with our comments.

Sincerely,

/s/ James G. Campbell

James G. Campbell
Vice President
Corporate Controller

[3] Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements (PCAOB) at A-85 and A-86.
[4] *See* 18 U.S.C. §§ 1348 and 1350 (2004) and 15 U.S.C. §78ff(a) (2004).

280 Park Avenue
New York, N.Y. 10017
8th Floor

Telephone 212-909-5600
Fax 212-909-5699

May 16, 2005

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

PCAOB Rulemaking Docket Matter No. 018
Proposed Auditing Standard –
Reporting on the Elimination of a Material Weakness
PCAOB Release No. 2005-002; March 31, 2005

Dear Mr. Secretary:

KPMG LLP appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness* (Proposed Standard). We fully support the Board's efforts to improve financial reporting, corporate governance and audit quality with the objective of furthering the public interest and restoring confidence in our capital markets system. Further, we support the Board in its efforts to develop a standard that establishes requirements and provides direction applicable when an auditor is engaged to report on the "elimination" of a material weakness in internal control over financial reporting.

This letter is organized by first providing our key comments and general observations on the Proposed Standard, including responses to specific questions posed in PCAOB Release No. 2005-02. Less significant and editorial comments and suggestions are included in Appendix A to this letter.

Key Comments and Observations

Use of the Term "Eliminate" – We believe that the terminology, "elimination of a material weakness," proposed for use both in management's and the auditors' reports, will result in misunderstanding by users relative to whether or not the underlying control deficiency has, in fact, been remediated. A user might reasonably conclude that, if management asserts, and the auditor attests, that a previously identified material weakness has been eliminated, then the underlying internal control deficiency no longer exists. This potential for misunderstanding also exists in those instances where a material weakness is the result of a number of aggregated deficiencies and certain, but not all, deficiencies that led to the material weakness have been remedied. Clearly, the Proposed Standard provides for reporting that a previously identified material weakness has been eliminated without requiring that the underlying control deficiency has been remedied.

In order to provide users with a more clear understanding of the extent of control deficiency remediation undertaken by management and reported on by the auditor, we recommend that the Board consider redirecting the auditors' reporting responsibility to relevant control objectives rather than to elimination of a material weakness. Specifically, we suggest that the auditors' report be directed toward providing assurance on the stated control objectives asserted by management to remedy the previously identified material weakness(es). The following excerpt from the standard auditors' report reflects revisions that illustrate this suggestion (order of paragraphs is revised):

> Management has asserted that the control(s) identified ~~above~~ **below** eliminates the **aforementioned** 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~~ **below** 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~~ **effectiveness of the control(s) identified below** ~~based on our auditing procedures~~.
>
> **[Describe control(s) implemented]**
>
> 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):~~ **the aforementioned control(s) was effective as of [date of management's assertion]**.
>
> ~~[Describe control(s) implemented]~~
>
> 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~~**control(s) was designed and operated effectively as of [date of management's assertion]**. 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~~ **the control** described above **was effective** as of [date of management's assertion] because the stated control objective ~~is~~ **was** met as of [date of management's assertion].

Previously Reported Material Weaknesses Not Yet Eliminated – We support the Board's approach outlined in the paragraph 52 of the Proposed Standard requiring the auditors' report to be modified when reporting on the elimination of fewer than all of the previously reported material weaknesses. To further clarify this matter, we recommend the Proposed Standard be revised to require that management, in its report, specify that its assertion does not extend to previously reported material weaknesses that are not the subject of the auditors' engagement to report on elimination.

Reporting on the Elimination of a Material Weakness Identified and Remediated as of an Interim Date – We believe that the Board, in its final standard, should provide that an auditor may report on the elimination of a material weakness only when such material weakness previously has been addressed in the issuer's Section 404 reporting. Paragraph E128 of Auditing Standard No. 2 indicates that, "The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct." Implicit in this statement is the recognition that the auditors' conclusion relative to the severity of an internal control deficiency is predicated on the performance of integrated audit procedures. In reporting on elimination, the auditor references the specified material weakness in the opinion paragraph. Accordingly, we believe that only those material weaknesses reported pursuant to an integrated audit engagement should be subject to auditor reporting on elimination.

Date of Assertion – Paragraph 26 of the Proposed Standard provides management with considerable flexibility in identifying a date as of which to make an assertion relative to elimination of a previously reported material weakness. We believe that the "as of" date for reporting on the elimination of a material weakness should be included in management's report and should coincide with an interim financial reporting date (i.e., an issuer's quarter-end). As indicated below, we believe that an auditor should perform some level of substantive audit procedures as part of an engagement to report on the elimination of a material weakness. Generally, we believe that it is impractical, and often not feasible, to perform substantive audit procedures other than at a financial statement close date. Accordingly, we recommend that the Board's final standard require that management's assertion relative to elimination of a material weakness coincide with the issuer's quarterly financial reporting date.

Substantive Audit Procedures – Paragraph 31 of the Proposed Standard indicates that, when reporting on the elimination of a material weakness, the auditor *may* determine that performing substantive audit procedures is necessary, depending on the nature of the material weakness. We believe that it rarely, if ever, would be appropriate for an auditor to conclude on the effectiveness of internal control without also performing some level of substantive audit procedures. As noted previously, paragraph E128 of Auditing Standard No. 2 evidences the importance of substantive audit procedures relative to concluding on the effectiveness of internal control over financial reporting. Accordingly, we recommend that the Board's final standard set forth a presumptively mandatory requirement for the auditor to perform relevant substantive audit procedures when reporting on the elimination of a material weakness in internal control over financial reporting.

* * * * *

Questions regarding information included in this letter should be directed to Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: Douglas R. Carmichael, Chief Auditor and Director of Professional Standards, Public Company Accounting Oversight Board
Thomas Ray, Deputy Chief Auditor, Public Company Accounting Oversight Board

The following editorial and other comments and suggestions are presented for your consideration:

1. Paragraph 2 of the Proposed Standard provides that an auditor may conduct an engagement to report on the elimination of a material weakness if the auditor has performed an integrated audit "within the past year." It is unclear as to what timeframe "within the past year" is intended to refer. For example, should the "as of" date for reporting on the elimination of a material weakness be within one year of the "as of" date for the most recent integrated audit, within one year of the auditors' report date related to the most recent integrated audit, or within one year of some other date such as the issuer's filing of its Form 10-K? We recommend that the Board's intent be clarified in its final standard. Reference to "within the past year" also appears in paragraph 22.

2. We recommend the following modification to the note in paragraph 6 of the Proposed Standard:

   > Obtaining and evaluating evidence about whether the specified controls are designed effectively without also obtaining evidence about whether those controls operated effectively **for a sufficient period of time** would not result in the auditor obtaining….

3. Paragraph 36 of the Proposed Standard, in illustrating how to apply the guidance on using the work of others in an engagement to report on the elimination of a material weakness, states (second paragraph of the example) "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." It is unclear to us why the walkthrough would be optional for the auditor since: a) paragraph 23b requires a walkthrough for "all major classes of transactions that are directly affected by controls specifically identified by management as eliminating the material weakness" (and we believe the controls in the example in paragraph 36 clearly fit this criterion); and b) paragraph 35 states that "the auditor should perform any walkthroughs himself or herself…." We recommend that the implication of the optional walkthrough or the option as to whether the auditor may use the work of others in the walkthrough be eliminated in the Board's final standard.

4. Paragraph 40 of the Proposed Standard indicates that, in an engagement to report on the elimination of a material weakness, the auditor should obtain a written representation from management "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." It is unclear to us as to the timeframe that this representation is intended to address. We recommend that the Board clarify the intent of this representation in its final standard.

5. The note to paragraph 47b of the Proposed Standard indicates that the "… report element should be modified in cases in which a successor auditor's performance of this engagement is his or her *initial* engagement [emphasis added]." To reflect what we believe is the Board's intent and to avoid potential confusion regarding the aforementioned reporting element when the successor auditor has not performed an integrated audit, but has performed another engagement (e.g., a review of interim financial information), we recommend that the subject sentence be revised as follows:

> This report element should be modified in cases in which a successor auditor **did not perform the integrated audit that led to reporting of the material weakness** ~~auditor's performance of this engagement is his or her initial engagement~~.

* * * * *

McGladrey & Pullen
Certified Public Accountants

3600 American Blvd. West
Third Floor
Bloomington, MN 55431-1082
O 952.921.7700 F 952.921.7702

May 15, 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*

Dear Mr. Secretary:

McGladrey & Pullen, LLP is pleased to submit written comments on the proposed auditing standard, *Reporting on the Elimination of a Material Weakness.* McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers. We support the PCAOB's efforts in responding to concerns expressed by registered public accounting firms as well as users of the audited financial statements with regard to this topic. However, we have identified certain issues that we believe require additional consideration by the PCAOB.

Achievement of Control Objective

We do not believe that a report on elimination of a material weakness is the appropriate place to introduce the concept of control objective. While we agree that a control objective can be thought of as the converse of "what can go wrong", we are concerned about introducing this concept in this report when it was not included in the auditor's report on internal control that originally reported the material weakness. However, if it is included, the report should be expanded to discuss the fact that control deficiencies, including significant deficiencies, can exist and the control objectives can still be met.

Paragraph 8 of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, (AS 2) states that a deficiency in the design of a control exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is *not always met*. It should also be noted that neither the definition of a significant deficiency (AS 2.9), nor the definition of a material weakness (AS 2.10) refer to whether or not the control objective has been met.

We believe that the linking of the elimination of a material weakness with the stated control objective *being met* is misleading to users of such reports. In fact, we believe there will be many instances where an issuer will put new controls in place that serve to lessen the severity of a control deficiency below that of a material weakness, but where a control deficiency or significant deficiency still remains. We are concerned that a user of such reports might infer from the wording of the opinion paragraph that the new controls operate at a level of effectiveness such that not only has the material weakness been eliminated, but also that no control deficiencies related to the control objective remain.

Material Weaknesses Resulting From Aggregation of Significant Deficiencies

Paragraph 14 of the proposed auditing standard states:

> "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."

We believe that additional guidance is needed in the proposed auditing standard to address situations where the previously reported material weakness resulted from an aggregation of significant deficiencies. For example, if a previously reported material weakness resulted from the aggregation of three significant deficiencies related to a specific account balance or class of transactions and each of the significant deficiencies resulted from the failure to meet different control objectives, would all three control objectives need to be met in order for the material weakness to be eliminated? We believe that in these circumstances, all control objectives related to the previously reported material weakness (aggregated) would need to be met in order for the material weakness to be eliminated.

Definition of Material Weakness

We believe that the sample auditor's report included in the proposed auditing standard does not clearly describe the results of the engagement because no definition of a material weakness is provided in the sample auditor's report. We believe that if an auditor is reporting on the elimination of a material weakness, that a definition of what has been eliminated should be included in the auditor's report. We believe that the inclusion of the definition of a material weakness in the auditor's report is needed to most clearly communicate the results of the engagement because the user of such reports needs to understand that the elimination of a material weakness simply means that the issuer has placed new controls in operation that results in the likelihood that a *material misstatement* of the annual or interim financial statements occurring has been reduced to remote.

Reasonable Assurance

Unlike the auditor's report on the audit of internal control, the sample auditor's report on the elimination of a material weakness does not include the concept of "reasonable assurance." We believe that in order for the auditor's report to clearly communicate the results of the engagement, the opinion paragraph of the auditor's report should reflect the concept of reasonable assurance.

Reporting When the Auditor Disagrees With Management's Assertion that a Material Weakness Has Been Eliminated

Paragraph 53 of the proposed auditing standard states that in situations where the auditor determines that the material weakness has not been eliminated as asserted by management, that the auditor is not required to issue a report, but rather could only communicate, in writing, his or her conclusion to the audit committee. We believe that would only be appropriate if management does not make an assertion in any SEC filing that the material weakness has been eliminated. However, if management makes such an assertion in any filing with the SEC and the auditor does not agree that the material weakness has been eliminated, we believe that the auditor should be required to issue a report containing an adverse opinion.

Obtaining Sufficient Knowledge of the Company's Business and Internal Control

Paragraph 23 of the proposed auditing standard provides guidance for situations where a successor auditor performs and engagement to report on the elimination of a material weakness as his or her initial engagement. We believe that the example provided in paragraph 23(a) is confusing. For example, a material weakness related to IT user access controls (an IT general control), while certainly having a pervasive effect, may not require a more extensive understanding of internal control over financial reporting in order to determine that the material weakness had been eliminated. Further, paragraph 23(a) of the proposed auditing standard directs the auditor to paragraphs 47 through 51 of AS 2, which states that the auditor must obtain an understanding of each of the five components of the COSO framework for internal control over financial reporting. The paragraph then continues by saying that the extent of understanding of internal control required depends on the nature of the material weakness on which the auditor is reporting. We believe that further clarification is needed with respect to paragraph 23 and that the example provided in the latter part of paragraph 23(a) is not useful in clarifying the intent of the paragraph.

Using the Work of Others

Paragraph 35 of the proposed auditing standard states, in part, that "the auditor *should* perform any walkthroughs himself or herself because of the degree of judgment required in performing this work." However, paragraph 36 of the proposed auditing standard provides an example that states, "The auditor *might* perform a walkthrough of the reconciliation process himself or herself." We believe that the auditor should always perform walkthroughs himself or herself, and thus the wording in paragraph 36 should be changed to "should" to be consistent with paragraph 35 of the proposed auditing standard.

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

Paragraph 47(b) of the proposed auditing standard states that in situations where a predecessor auditor's report on management's most recent annual assessment of the effectiveness of internal control over financial reporting identified a material weakness, the successor auditor's report on the elimination of the material weakness should refer to the predecessor auditor's report *if necessary*. We believe that the successor auditor's report on the elimination of a material weakness should directly refer to predecessor auditor's report (unless the material weakness was identified as of an interim date).

Thank you for the opportunity to comment on the proposed auditing standard. Questions concerning our comments should be directed to Leroy Dennis (952.921.7627), Bruce Webb (515.281.9240) or Bob Dohrer (952.921.7762).

Very truly yours,

McGladrey & Pullen, LLP

Moody's Investors Service

99 Church Street
New York, New York 10007

Gregory J. Jonas
Managing Director
Tel: 1.212.553.1449
Email: gregory.jonas@moodys.com

May 5, 2005

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

Re: Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness
(PCAOB Rulemaking Docket Matter No. 018)

Moody's Investors Service supports the PCAOB's proposed auditing standard on the reporting on the elimination of a material weakness.

As discussed in our recently published Special Comment, *Section 404 Reporting on Internal Control: Our Early Experience*, we believe there are two areas where disclosure about material weaknesses could be improved:

- First, many companies could often be more specific about the nature of material weaknesses they report. Vague generalizations raise more questions than they address. More detail would help users better understand the relative severity of the material weaknesses and would reduce uncertainty about a company's financial reporting.
- Second, companies could be more specific about their plans to remediate material weaknesses and the timing for doing so. Some companies disclose little about their remediation plans.

Looking forward, we expect that many companies will update users in their quarterly filings on their progress toward remediation of material weaknesses. We welcome those updates. We would also welcome an auditor's report on the successful elimination of a material weakness when it occurs, rather than waiting until the next annual reporting cycle.

As discussed in our Special Comment, *Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported*, dated October 2004, we consider all material weaknesses in our credit ratings. Under our approach, management's response to a material weakness is critical; we try to assess whether management is taking the problem seriously and that timely correction is underway. Just as we value disclosure about material weaknesses, we also value disclosure about their timely remediation. Similarly, just as we value auditor attestation about material weaknesses, we also would value auditor attestation about their remediation.

We understand that auditors currently evaluate management's quarterly certifications about changes in internal control over financial reporting. On the one hand, the auditor's procedures during interim periods, primarily observation and inquiry, are limited and not sufficient to allow the auditor to attest to remediation. On the other hand, requiring a complete re-assessment of internal control over financial reporting during an interim period would be costly and time consuming.

We believe the proposed standard strikes a useful balance by giving companies the option to provide users with information they value and with the assurance they find useful while not requiring a complete re-assessment.

The following responds to your particular questions:

1. 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?

   Yes.

2a. 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?

   Yes. Failure to identify the additional material weaknesses might lead some users to erroneously conclude they no longer exist, or that the auditor overlooked them. Also, reference to these material weaknesses in the auditors' report maintains the linkage between management's disclosures and the auditor's report, which we find useful.

2b. 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 <u>do</u> 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)?

   It would provide helpful information. However, if reported, users would likely conclude that those material weaknesses still exist. This is because if management had remediated those material weaknesses, management would likely have requested the auditor to attest to that remediation too. As a result, we see little chance of corrected material weaknesses being identified in the auditor's report as still existing.

   We doubt that users would incorrectly interpret the auditor's report as providing assurance that no new material weaknesses have arisen since the date of the last annual assessment. Your proposed auditor's report makes clear that the engagement is limited only to reporting on the elimination of a material weakness.

2c. 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?

Perhaps. However, we believe that auditor's reports should refer to those weaknesses for the reasons described above.

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

Yes. However, in doing so, it is important for the auditor's report to clearly distinguish between (i) material weaknesses identified in the company's last annual assessment (i.e., in the company's Section 404 reporting) and (ii) material weaknesses subsequently identified and eliminated by management. Without clearly distinguishing between the two, some users might erroneously conclude that the auditor has performed a complete re-assessment of the company's internal control over financial reporting.

Moody's appreciates the opportunity to comment. If you should have any questions, please contact me at (212) 553-1449 or Michael Doss at (212) 553-1919.

Sincerely,

Gregory J. Jonas
Managing Director

NASBA
National Association of State Boards of Accountancy
150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417
Tel 615/880-4200 Fax 615/880-4290 Web www.nasba.org

May 10, 2005

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via e-mail to: **comments@pcaobus.org**

Re: PCAOB Release No. 2005-002 March 31, 2005:
PCAOB Rulemaking Docket Matter No. 018

Dear Board Members:

We appreciate the opportunity to offer comment to the Public Company Accounting Oversight Board ("Board") on the Proposed Auditing Standard - Reporting on the Elimination of a Material Weakness ("Proposal"). The National Association of State Boards of Accountancy's (NASBA's) primary goal is to increase the effectiveness of US state boards of accountancy. In furtherance of that goal, our Professional and Regulatory Response Committee ("Committee") offers the following comments on the proposed rules:

The Board has invited comments on the proposal to permit, on an entirely voluntary basis, a company to engage its independent auditor to conduct an engagement to report on the company's assertion that the company has eliminated a previously disclosed material weakness in internal control over financial reporting.

The Proposal permits a company to engage its independent auditor to report on the elimination of any or all previously disclosed weaknesses (i.e., disclosed in an auditor's report issued pursuant to Auditing Standard No.2) as of a date specified by management. If requested by the company, the auditor may conduct an engagement to report on the elimination of more than one material weakness.

Paragraph 52 of the Proposal addresses the language to be used in a report where the auditor has been engaged to report on only some of the previously disclosed material weaknesses. While the proposed language requires the auditor's report to state that it does not cover whether the other material weaknesses have been eliminated, it does not require the report to specify the nature of the other material weaknesses. Because of the voluntary nature of the Proposal, a company can pick and choose which weaknesses, if any, should be the subject of the auditor's report. The Committee believes that the auditor's report (or possibly some other document) should keep a scorecard of the status of the elimination of weaknesses by indicating specifically the weaknesses that have not been reported on.

The Proposal, as written, limits the auditor to reporting on material weaknesses previously disclosed in an auditor's report issued pursuant to Auditing Standard No.2. The Proposal invites comment as to whether the standard should "allow the auditor to report on the elimination of a material weakness in the circumstances in which the material weakness was identified and eliminated by management as of an interim date." The Committee believes that permitting such reporting would be in harmony with the reason for the proposed issuance of the standard, which was the call by some investors and companies for a mechanism for confirmation by the independent auditors of internal control improvements. (See Briefing Paper March 31, 2005 Public Meeting of the Board, page 2.)

The Committee notes that the Proposal refers to the "elimination" of a material weakness. The Committee believes that the word "eliminated" may be too final a term and would suggest the substitution in the proposed standard of the word "rectified" or "corrected."

Paragraph 26 of the Proposal (Page A1-12) speaks to the date that management specifies is the date that the material weakness was eliminated. The Committee recommends to the Board that the Board consider an auditing standard that would require a company to specify the date that management asserts is the date that on which a material weakness had been rectified.

Although the Committee supports the concept of this voluntary standard, the Committee would not be surprised if the voluntary standard becomes a *de facto* standard in practice, considering the current reporting environment. Factors beyond the control of the Board will likely dictate whether or not the standard remains a truly voluntary one.

We hope these comments will assist the Board in its work.

Very truly yours,

Michael D. Weatherwax, CPA
NASBA Chair

David A. Costello, CPA
President & CEO

new york state society of
NYSSCPA
certified public accountants

Home of the Trusted Professional
3 park avenue, at 34th street, new york, ny 10016-5991
212.719.8300 • fax 212.719.3364
www.nysscpa.org

May 11, 2005

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

By e-mail: comments@pcaobus.org

Re: PCAOB Release No. 2005-002 - Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness, March 31, 2005.

Dear PCAOB Board Members:

The New York State Society of Certified Public Accountants, the oldest state accounting association, representing approximately 30,000 CPAs, endorses the PCAOB's proposal to create a mechanism for engagements to report on the elimination of internal control weaknesses. The increased focus on internal control is a positive development, which, however, carries with it negative repercussions to issuers that have other than a clean opinion at their year-end audit. This proposed standard provides an incentive for early correction of internal control weaknesses by permitting the auditor to issue an internal control attestation on an interim basis.

Overall, the standard is well written and consistent with AS 2, but additional attention should be paid to the following issue:

- Although such engagements are designed to be narrowly focused on very specific controls, testing cannot be carried out in complete isolation from the rest of the internal control system. Therefore, in principle, other internal control weaknesses could come to the auditor's attention that are neither the subject of the current engagement nor identified as weaknesses at the year-end audit. The standard should address what the auditor's responsibilities are in pursuing such cases when they arise and how the identification of a new weakness should be reported.

- Some non-standard reporting examples should also be provided.

The NYSSCPA's Auditing Standards and Procedures Committee drafted these comments. If you would like additional discussion with us, please contact the committee chair, Mark Mycio at (212) 372-1421, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

John J. Kearney
President

NYSSCPA 2004 - 2005 Board of Directors

John J. Kearney,
President

Stephen F. Langowski,
President-elect
Raymond M. Nowicki,
Secretary
Arthur Bloom,
Treasurer
Peter L. Berlant,
Vice President
Katharine K. Doran,
Vice President
Andrew M. Eassa,
Vice President
Louis Grumet, *ex officio*

William Aiken
Deborah L. Bailey-Browne

Spencer L. Barback
Thomas Patrick Casey
Andrew Cohen
Ann B. Cohen
Michelle A. Cohen
Walter Daszkowski
Anthony G. Duffy
Barbara S. Dwyer
Robert L. Ecker
Mark Ellis
David Evangelista
Phillip E. Goldstein
Neville Grusd

David W. Henion
Raymond P. Jones

Don A. Kiamie
Nancy A. Kirby
John J. Lauchert
Howard B. Lorch
David J. Moynihan
Robert S. Peare
Richard E. Piluso
Joseph J. Schlegel
Robert E. Sohr
C. Daniel Stubbs, Jr.
Edward J. Torres
Robert N. Waxman
Philip G. Westcott
Philip Wolitzer

NYSSCPA 2004 - 2005 Accounting & Auditing Oversight Committee

Paul D. Warner, Chair
Gary E. Carpenter
Joseph W. Duggan
Robert A. Dyson
David J. Hasso
Elliot L. Hendler
Michele M. Levine

Thomas O. Linder
Eugene D. Mahaney
Robert S. Manzella
Mark Mycio
Eric J. Rogers
Mitchell Rosendorf

Steven Rubin
Ira M. Talbi
George I. Victor
Robert N. Waxman
Paul J. Wendell
Margaret A. Wood

NYSSCPA 2004 - 2005 Auditing Standards and Procedures Committee

Mark Mycio, Chair
Anthony Basile
Robert W. Berliner
Frank A. Bianculli
Christopher A. Brown
Romolo R. Calvi
Kyu Cho
Michael H. Ehrenpreis
Philip Gaboury

Fred R. Goldstein
Neal B. Hitzig
Mary-Jo Kranacher
Elliot A. Lesser
Joseph E. Manfre
Stephan R. Mueller
Lawrence E. Nalitt
Wayne Nast
Bruce H. Nearon

Bernard H. Newman
Raymond A. Norton
Richard G. O'Rourke
Victoria L. Pitkin
Gentiana Shameti
Thomas Sorrentino
George I. Victor
William H. Walters
Robert N. Waxman
Barry Wexler

NYSSCPA Staff

Robert H. Colson

May 16, 2005

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Subject: PCAOB Rule Making Docket Matter No. 018

Dear PCAOB Members:

The North Carolina State Board of CPA Examiners (Board) has reviewed the Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness. It is the Board's opinion that the proposed standard, working in concert with the reporting and audit requirements of Section 404 of the Sarbanes-Oxley Act of 2002, will allow the investing public to assess the condition of internal controls of public companies over financial reporting on a more timely basis which is so critical to our investing public and the markets they so importantly participate in.

The Board believes that the sample auditor's report included in the proposed standard clearly describes the nature and results of the engagement.

The Board believes if the auditor does not express an opinion on all material weaknesses that were identified during the company's most recent annual audit of internal control over financial reporting the proposed standard should not require the auditor's report to specifically identify the additional material weaknesses. The Board's believes that a separate paragraph explaining that the auditor is only reporting on the material weaknesses required to be specifically identified in the report and that other material weaknesses were identified in the annual report on management's assessment of the company's internal control over financial reporting is a more clear communication.

Lastly, the board believes that the standard should allow an auditor to report on the elimination of a material weakness in circumstance in which the material weakness was identified by the auditor or management and eliminated by management as of an interim date and therefore not addressed in the company's Section 404 reporting.

The Board is very appreciative of the PCAOB's efforts to improve the auditing standards relating and therefore the quality and reliability of work performed by CPAs.

Sincerely,

Leonard W. Jones, CPA
President

OPERS Ohio Public Employees Retirement System
277 East Town Street Columbus, Ohio 43215-4642 1-800-222-PERS (7377) www.opers.org

Sent via e-mail to: comments@pcaobus.org

April 15, 2006

Mr. J. Gordon Seymour, Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 018, Proposed Auditing Standard on Corrections of Material Weaknesses in Internal Control Over Financial Reporting

Dear Mr. Seymour:

The Ohio Public Employees Retirement System ("OPERS") is a more than $64.5 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S. We are writing in response to the Public Company Oversight Board ("PCAOB") request for comments regarding its proposed auditing standard on reporting on the elimination of a material weakness in internal controls prior to the next annual assessment.

OPERS applauds the PCAOB for proposing a flexible auditing standard for those companies seeking to provide investors with additional reliable information, on an interim basis, that a material internal control weakness has been corrected. According to a recent Glass Lewis & Co. study, in the first quarter of 2005, 263 companies disclosed material weaknesses and, as reported in Compliance Weekly, 582 companies founds weaknesses or deficiencies in their internal controls in 2004.

Disclosure of a material weakness in internal controls has the potential to depress a company's stock price. The elimination of a material weakness, accompanied by an independent auditor's interim report attesting to management's assessment of its internal controls, will increase investor confidence in the reliability of a company's financial statements. The PCAOB has done an exemplary job of responding to public company and investor concerns by proposing this voluntary remediation standard.

Thank you for providing this opportunity to comment. Should you need any additional information, please contact Cynthia L. Richson, Corporate Governance Officer, at 614.222.0398.

Sincerely,

Laurie Fiori Hacking

Laurie Fiori Hacking
Executive Director

Ohio **R**etirement **S**ystems

Damon Asbury
Executive Director
State Teachers Retirement System of Ohio
275 East Broad Street
Columbus, Ohio 43215
Telephone: (614) 227-4090
▪
Richard Curtis
Executive Director
Highway Patrol Retirement System
6161 Busch Blvd., Suite 119
Columbus, Ohio 43229
Telephone: (614) 431-0781
▪
William Estabrook
Executive Director
Ohio Police and Fire Pension Fund
140 East Town Street
Columbus, Ohio 43215
Telephone: (614) 228-2975
▪
Laurie Hacking
Executive Director
Ohio Public Employees Retirement System
277 East Town Street
Columbus, Ohio 43215
Telephone: (614) 222-0011
▪
James R. Winfree
Executive Director
School Employees Retirement System of Ohio
300 East Broad Street
Suite 100
Columbus, Ohio 43215
Telephone: (614) 222-5853
▪
Keith Overly
Executive Director
Ohio Public Employees Deferred Compensation
250 Civic Center Drive
Columbus, Ohio 43215
Telephone: (614) 466-7245

Sent via e-mail to: comments@pcaobus.org

April 26, 2005

Mr. J. Gordon Seymour, Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 018, Proposed Auditing Standard on Corrections of Material Weaknesses in Internal Control Over Financial Reporting

Dear Mr. Seymour:

The Ohio Retirement Systems (ORS) collectively manage $142 billion in assets and serve 1.5 million Ohioans. We are writing in response to the Public Company Accounting Oversight Board ("PCAOB") request for comments regarding its proposed auditing standard on reporting on the elimination of a material weakness in internal controls prior to the next annual assessment.

ORS applauds the PCAOB for proposing a flexible auditing standard for those companies seeking to provide investors with additional reliable information, on an interim basis, that a material internal control weakness has been corrected. According to a recent Glass Lewis & Co. study, in the first quarter of 2005, 263 companies disclosed material weaknesses and, as reported in Compliance Weekly, 582 companies found weaknesses or deficiencies in their internal controls in 2004.

Disclosure of a material weakness in internal controls has the potential to depress a company's stock price. The elimination of a material weakness, which may be voluntarily accompanied by an independent auditor's interim report attesting to management's assessment of its internal controls, will increase investor confidence in the reliability of a company's financial statements. The PCAOB has done an exemplary job of responding to public company and investor concerns by proposing this voluntary remediation standard.

Mr. J. Gordon Seymour
April 26, 2005
Page 2

Thank you for providing this opportunity to comment. Should you need any additional information, please contact Cynthia L. Richson, Corporate Governance Officer for the Ohio Public Employees Retirement System, at 614.222.0398.

Sincerely,

Damon F. Asbury
Executive Director
State Teachers Retirement System of Ohio

Richard A. Curtis
Executive Director
Highway Patrol Retirement System

William J. Estabrook
Executive Director
Ohio Police and Fire Pension Fund

Laurie Fiori Hacking
Executive Director
Ohio Pubic Employees Retirement System

James R. Winfree
Executive Director
School Employees Retirement System of Ohio

R. Keith Overly
Executive Director
Ohio Public Employees Deferred Compensation

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
500 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 7000
Facsimile (973) 236 7200

May 16, 2005

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

Re: PCAOB Rulemaking Docket Matter No. 018, Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness* (PCAOB Release No. 2005-002, March 31, 2005)

Dear Mr. Secretary:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the proposed auditing standard, *Reporting on the Elimination of a Material Weakness* (the "proposed standard"), of the Public Company Accounting Oversight Board (the "Board").

We fully support the Board's efforts to provide a standard under which the auditor could perform an audit-level engagement to report on management's elimination of a material weakness that previously was identified by the auditor in an integrated audit. We believe the proposed standard strikes the proper balance in a number of important ways:

- It requires that the auditor's responsibilities parallel those under the Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS 2").
- It appropriately makes the engagement elective by companies.
- It properly recognizes that there will be some instances where a narrow, interim engagement may not be suitable for auditor reporting because of an inability to assess the operating effectiveness of remediated controls, e.g., effectiveness of the control environment.

Recommendations

We have several recommendations that we believe will contribute to the achievement of the goals of the proposed standard. These address the following:

- Auditor's report
- An interim review-level service as an alternative
- Reasonable assurance and materiality
- When the engagement might be conducted

Auditor's Report

Generally, the auditor's report included in the proposed standard clearly describes the results of the engagement. However, we recommend that the auditor's opinion be restricted to the elimination of the material weakness and not be required to also state that the elimination of the material weakness resulted from achieving a stated control objective. We believe the proposed standard, by tying the auditor's opinion to reporting on achieving a stated control objective, inappropriately establishes a different framework for reporting on the elimination of the material weakness than that governing the original reporting of its existence. Reporting under AS 2 is within the framework of the stated control criteria (e.g. COSO), which is broad and addresses the overall objective of effective internal control over financial reporting rather than the achievement of specific control objectives.

We believe that for purposes of this engagement, materiality should be referenced explicitly in the opinion paragraph of the auditor's report. We also recommend that the proposed standard state that such reference should be in the context of the company's overall internal control over financial reporting, which is the same context as that in which the control deficiency originally was concluded to be a material weakness.

The following reflects revised opinion language that, in our view, would be appropriate:

> In our opinion, management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of elimination as indicated in management's assertion*] is fairly stated, in all material respects, in relation to XYZ Company's internal control over financial reporting taken as a whole.

Similarly, the last sentence of the third paragraph of the auditor's report would be modified to read:

> Our responsibility is to express an opinion on management's assertion regarding elimination of the material weakness based on our auditing procedures.

An Interim Review-Level Service as an Alternative

We recommend that the proposed standard permit an interim review-level service as an alternative to an audit of the elimination of a material weakness. While a review-level service would provide less assurance, we believe its availability would be of benefit to the capital markets. Compared with the proposed engagement and depending on the specific facts and circumstances, a review might permit an auditor to provide limited reporting on a more timely basis on the new design of the remediated controls in areas where an interim audit of operating effectiveness could not be performed. As we envision such review, the auditor's procedures would be limited and consist principally of inquiry, observation, and limited examination of evidence (possibly including walkthroughs) relating to management's assertion that the remediated controls have been suitably designed and placed in operation. Neither management nor the auditor would be required to report on operating effectiveness of the remediated controls. The auditor's report would speak to whether or not anything came to the auditor's attention indicating that the remediated controls had not been suitably designed and placed in operation, and, if operating effectively, would not eliminate the material weakness.

Reasonable Assurance and Materiality

Paragraph 5 of the proposed standard states that "the auditor must plan and perform the engagement to obtain reasonable assurance about whether the company has eliminated the material weakness," with no reference to materiality. On the other hand, paragraph 4 of AS 2 states that "the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, *in all material respects*, effective internal control over financial reporting as of the date specified in management's assessment" [emphasis added]. Consistent with our previous comment on the auditor's report, we believe that for purposes of planning and performing this engagement, the auditor should assess materiality in the context of the company's overall internal control over financial reporting, that is, in the same context as that in which the control deficiency originally was concluded to be a material weakness. Otherwise, auditors might interpret their responsibility to obtain audit evidence with respect to a specific control or control objective as greater in this engagement than in an audit of internal control over financial reporting. Such an interpretation would require the auditor to do relatively more work in order to conclude that management's assertion that the material weakness has been eliminated is fairly stated in a narrower context. We do not believe this interpretation would be appropriate. For example, we do not believe an auditor generally would be required to test larger samples of transactions for purposes of this engagement than the samples tested to support the original determination that a material weakness existed.

Paragraph 20 states: "… the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness exists." In line with our comments in the preceding paragraph, we recommend that this paragraph be revised to clarify that the auditor uses materiality at the financial-statement level as well in evaluating whether a material weakness has been eliminated.

We recommend that additional guidance be provided relating to the appropriate time context for management's and the auditor's materiality judgments. For example, is materiality assessed as of the date management asserts to be the date at which the material weakness has been eliminated or, alternatively, should the auditor use materiality as assessed at the end of the prior year when the material weakness originally was reported? Could a material weakness be eliminated merely as a result of an acquisition (e.g., materiality changed as a result of the acquired business) or a disposition (e.g., the material weakness related exclusively to the business disposed of)? In our view, management's and the auditor's assessments of materiality should be in the context of annual and interim financial reporting at the "as of" date of management's assertion that the material weakness has been eliminated. As a result, a material weakness could be eliminated merely as a result of an acquisition or a disposition.

When the Engagement Might Be Conducted

The discussion accompanying the proposed standard states that the engagement could be undertaken at any time during the year and would not have to be performed in conjunction with an audit or review of the financial statements. We believe this is inconsistent with one of the fundamental underpinnings of AS 2, the concept of an integrated audit, and accordingly recommend that the engagement be restricted to a quarterly basis (i.e., the end of a quarter), so that both management and the auditor can integrate their work with their existing respective responsibilities for the preparation and review of quarterly financial information. In our view, such integration would significantly benefit both management and the auditor in concluding on the elimination of a material weakness. For example, allowing these engagements only on a quarterly basis would assist both management and auditors in assessing materiality.

The proposed standard points out, "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. Therefore, investors will learn of significant improvements, such as the elimination of a material weakness, on a timely basis through quarterly disclosures." We believe, for consistency, auditor reporting on the elimination of a material weakness similarly should be restricted to a quarterly basis and be directly related to management's required quarterly disclosures regarding material changes in internal control.

Also, we believe the company needs to be able to demonstrate that the control that has been remediated is operating in conjunction with the entire financial reporting process and therefore would need to gain that understanding though a complete quarterly reporting process. Without the completion of the entire reporting cycle, management and the auditor may not have sufficient evidence to demonstrate that the control objective and related financial statement assertion are achieved.

Other Matters

In addition, we have provided our answers to the Board's specific questions as well as more detailed comments below.

Auditor's Report

In addition to the above comments on the auditor's report, we have the following recommendations:

- While the penultimate paragraph of the report properly indicates that the auditor did not conduct an audit of internal control over financial reporting as of the interim date, a similar statement should be added that the auditor also did not conduct a financial statement audit as of such date. In addition, paragraph 47 should be revised to include this as an additional element of the auditor's report.

- We recommend that the last sentence of the penultimate paragraph of the auditor's report be revised to read as follows: "Accordingly, we do not express an opinion that internal control over financial reporting on an overall basis or with regard to any controls other than those stated above operated effectively after December 31, 200X."

- The report indicates the "as of" date to be the date of management's assertion. To be consistent with Section 404, which does not require that management's assertion be dated, we recommend that the date instead be that which management asserts to be the date at which the material weakness has been eliminated.

Identification of Additional Material Weaknesses Not Being Reported on

In cases where the auditor does not express an opinion on all of the material weaknesses identified during the most recent audit of internal control over financial reporting, the auditor's report should not specifically identify the additional material weaknesses. While specific identification of uncorrected material weaknesses would not, in our view, deter companies from engaging auditors to perform such engagements, it could confuse readers as to the scope of the engagement. Accordingly, we believe the guidance and sample language contained in paragraph 52 of the proposed standard is appropriate in such circumstances.

Reporting on the Elimination of Material Weaknesses Identified by Management at an Interim Date

The proposed standard appropriately precludes an auditor from reporting on the elimination of a material weakness 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 and in an integrated audit performed under AS 2). In our view, to be able to assess whether a material weakness has been eliminated, the auditor needs knowledge of the specific facts and circumstances that can result only from management's and the auditor's conclusions as a result of a complete assessment of internal control over financial reporting.

Applicability of the Proposed Standard

The types of circumstances in which an engagement under the proposed standard may or may not be appropriate are discussed in two paragraphs on pages 5 and 6 of the release. The first provides an example (not reconciling cash accounts) of a situation where a material weakness might lend itself more easily to auditor assurance on an interim basis. The second provides an example (a pervasive weakness in the control environment) of a situation that may not be suitable for this type of engagement. Also, the last paragraph on page 7 of the release discusses material weaknesses having a pervasive effect. We believe this guidance should be included in the applicability section of the proposed standard.

In addition, we recommend that the proposed standard incorporate guidance on circumstances, if any, in which the auditor might report at an interim date on the elimination of a material weakness relating to controls that operate only at year end.

Conditions for Engagement Performance

To be consistent with AS 2, we recommend that the words "including documentation" be added following the words "sufficient evidence" in paragraph 7d.

The Concept of Control Objective

The proposed standard gives new prominence to the concept of "control objective" and includes it as an element of management's and the auditor's reporting. The sample report in Appendix A of the proposed standard contains two mentions of the term:

- "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*" [emphasis added].

- "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*]" [emphasis added].

We understand the Board's intent in elevating the concept of control objective. However, the term, while mentioned generally in various places in existing standards, and a few times in COSO's *Internal Control – Integrated Framework*, lacks a common definition and guidelines for its use. Auditors today define and apply this concept differently in their various audit methodologies and, as pointed out in the proposed standard, management establishes control objectives tailored to the individual company. We can easily envision situations where management and auditors would find it difficult to agree on the definition and scope of a specific control objective, complicating their judgments as to what control objective was achieved that resulted in eliminating the material weakness. Because of this, we believe additional guidance is needed regarding control objectives to ensure understanding and consistent use of the concept by management and auditors.

Control Objectives – Controls in Combination and Components other than Control Environment

The proposed standard does not address situations where a combination of controls is necessary to achieve a specific control objective. This concept is recognized in paragraph 12 of AS 2, which states: "… effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." For example, assume that three controls were required to operate effectively in order to achieve a control objective relating to completeness. At the latest integrated audit, two of the controls operated effectively. However, the ineffectiveness of the third control resulted in a material weakness because the completeness objective was not achieved. In our view, the auditor should be required as part of this engagement to test all three controls and not only the one that failed and resulted in a material weakness. We recommend that the proposed standard specifically address this area.

Also, auditors would benefit from guidance expanding on the last sentence of paragraph 11 as to how control objectives would be expressed with regard to internal control components other than control activities, that is, the control environment, risk assessment, information and communication, and monitoring. We also suggest that the table in paragraph 13 be expanded to include examples of control objectives for internal control components other than control activities.

Controls "Directly" vs. "Indirectly" Affecting the Achievement of Control Objectives

The note to paragraph 23b. discusses the indirect effect of certain controls, for example, certain controls in the control environment and risk assessment components, without addressing whether such controls would need to be within the auditor's scope if they indirectly affected achievement of the control objective(s) relating to the eliminated material weakness. Since a successor auditor's walkthrough is required only for major classes of transactions that are *directly affected* by controls eliminating the material weakness, the implication appears to be that only controls directly affecting achievement of the control objective need to be included in management's and the auditor's assessments. In our view, pervasive controls, such as those that are part of the control environment, should not be required to be audited in the numerous cases where they have only an indirect effect on the achievement of the control objective related to a material weakness at an account-balance/assertion level. Rather, the decision should be left to the auditor's judgment. We recommend that the proposed standard be explicit in this area.

Aggregation and Compensating Controls

A material weakness may be the result of the aggregation of more than one control deficiency. We believe the proposed standard should provide guidance on how the elimination of such material weaknesses would be addressed. For example, would it be sufficient for the company to remediate—and the auditor test—controls that resulted in one of a number of significant deficiencies that caused the material weakness, assuming the others would not aggregate to a material weakness on their own? Alternatively, would all control deficiencies included in the original aggregation be required to have been eliminated and the remediated controls tested by the auditor? We believe that once a material weakness is determined as a result of the combination of a number of control deficiencies, to eliminate the material weakness, all the control deficiencies need to be eliminated for purposes of this engagement. Without this requirement, it will be difficult, if not impossible, for management and the auditor to determine the individual effect that each control deficiency had on the original determination of the aggregated material weakness.

We suggest adding in paragraph 9 of the proposed standard a statement that the elimination of a material weakness may mean that the material weakness was eliminated because its significance was reduced to the level of a significant deficiency or a control deficiency. This could come from the addition of compensating controls that prevent the control deficiency from resulting in a misstatement that is material.

Period-End Financial Reporting

We recommend that the following phrase be added to paragraph 26d: "(e.g., controls over the preparation of annual financial statements and related disclosures typically operate only as of year-end and therefore an interim report on the elimination of a material weakness would not be appropriate)".

Using the Work of Others

In the third to last sentence of the note at the end of paragraph 36, we recommend that the phrase "in most cases" be eliminated. We have difficulty envisioning a situation where the auditor could use the work of others without performing any of his or her own procedures with regard to a remediated control and still be able to meet the principal evidence requirement.

Management's Representations

We believe the guidance on management's required written representations regarding subsequent events in paragraph 40g. should be expanded to clarify that such subsequent events would be those that indicate that the remediated control(s) was not operating effectively at the "as of" date as well as those that indicate the remediated control(s), while operating effectively at the "as of" date, subsequently was shown not to be operating effectively.

Paragraph 41 of the proposed standard states that the auditor should evaluate the effects of management's refusal to furnish written representations 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." We believe the phrase in quotes, while appropriate in the context of an integrated audit performed under AS 2, is inappropriate for purposes of this engagement and should be eliminated.

Subsequent Events

Paragraph 55 limits the guidance on subsequent events to those occurring after the date of management's assertion but before the date of the auditor's report. We believe guidance, similar to that in paragraphs 197 through 199 of AS 2, should be added with regard to the auditor's responsibilities after the date of the auditor's report.

The first bullet in paragraph 55 restricts the auditor's inquiries about and examination of internal auditor reports to those "relevant to the stated control objective or identified controls issued during the subsequent period." We believe the other bullets in this paragraph should be similarly restricted.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions the staff may have. Please do not hesitate to contact Raymond Bromark (973-236-7781) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

STATE BOARD OF ADMINISTRATION OF FLORIDA
1801 HERMITAGE BOULEVARD
TALLAHASSEE, FLORIDA
32308
(850) 488-4406

VIA EMAIL

May 16, 2005

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

Re: PCAOB Rulemaking Docket Matter No. 018

Dear Sir or Madam:

The State Board of Administration (SBA) of Florida is writing in support of the PCAOB's proposed Auditing Standard, "Reporting on the Elimination of a Material Weakness."

Managed by the SBA, the Florida Retirement System (FRS) is the fourth largest public pension plan in the United States with approximately 850,000 beneficiaries and retirees, and assets totaling approximately $107 billion. As a large institutional investor in global capital markets, the SBA has a significant interest in promoting accurate financial information in order for investors to make reasonably informed decisions and for the orderly functioning of the U.S. capital markets. We believe the proposed standard addresses the need of investors to know whether previously reported material weaknesses[1] in a company's internal controls have been ameliorated. The SBA believes that this standard is a reasonable response to an issue unaddressed by Auditing Standard 2 (A.S. 2)[2].

As background, the SBA believes Section 404 is a core piece of the Sarbanes-Oxley Act and was enacted in response to well-documented failures of internal controls at a number of high-profile U.S. companies. Under Section 404 of the Act, for the first time, the investing public has received audited financial statements coupled with reports from management and the auditor explaining the soundness of the control system used to produce the financial statements. While the recent focus over this important provision has centered on the costs of Section 404, we strongly believe the benefits of 404 are significant and outweigh short-run implementation charges. As voiced by many different parties in a recent SEC/PCAOB roundtable, panelists discussed a range of realized and expected benefits including an improved "tone at the top," more

[1] Defined as those weaknesses in a company's internal controls that could lead to a potentially material error in the financial statements.
[2] The SBA views A.S. 2 as fundamentally sound and not in need of major overhaul. It appropriately recognizes that reviews shouldn't be a checklist or a one-size fits all exercise, it appropriately requires auditors to exercise professional judgment, and it appropriately gives auditors the discretion to rely on the work of others. It does not require testing of all controls—only those that are intended to make it probable that the financial statements are materially wrong.

involved boards of directors, more robust audits by external auditors, enhanced internal audit resources and performance, higher quality financial statements and fewer restatements of company financials. Although these benefits are long-term in nature and may be difficult to quantify, such efforts will be a positive for all involved in the U.S. capital markets.

Section 404 is identifying problems with internal controls, and it is indicating that some companies have significant internal control deficiencies[3]. Some of these lacking controls must be reported to investors as material weaknesses but many others are being identified and remediated before disclosure is required. Until the company eliminates the material weakness, however, investors may be left uncertain about the reliability of the company's financial statements. Although companies have an obligation on a quarterly basis to report any material changes in their internal controls, including a remediation of previously disclosed material weaknesses, verification[4] by an independent auditor of a remediation will undoubtedly benefit investors. As noted within the proposed standard, "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."

The proposal has been flexibly structured in order to give companies the ability, on a voluntary basis, to seek an auditor's opinion that one or more material weaknesses have been corrected and allows the engagement to be undertaken at any time during the year. The proposal also provides guidance to audit firms for issuing such an opinion—requiring the auditor's opinion to identify explicitly the material weakness in question and to restrict the auditor's conclusion with respect to the effectiveness of other controls.

I commend the PCAOB's efforts to promote and enhance accurate financial information for the investment community.

Sincerely,

Coleman Stipanovich
Executive Director

cc: Ms. Kayla Gillan, Board Member, PCAOB
Mr. Donald Nicholiasen, Chief Accountant, SEC
Mr. Kurt Schacht, Executive Director, CFA Centre for Financial Market Integrity
Ms. Ann Yerger, Executive Director, Council of Institutional Investors

---

[3] At least one research firm has noted the positive correlation between control deficiencies and financial restatements, separate and apart from the negative effect that strong internal controls have on financial defalcations.

[4] An auditor would perform an evaluation of management's assertion and the performance of audit procedures necessary to determine that the controls specified in management's assertion were designed and operated effectively to eliminate the material weakness.

Texas Society of
Certified Public Accountants

May 11, 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

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters.

We appreciate the opportunity to provide input into your deliberations on the Proposed Auditing Standard – *Reporting on the Elimination of a Material Weakness*.

Regarding the three areas where specific comments were requested, we have the following input:

1. In our opinion, the sample auditor's report included in the proposed standard adequately describes the results of the engagement.

2. We believe the requirement to modify the report in an attempt to point out that other material weaknesses were previously identified, and are not currently being addressed, is sufficient. Readers who are interested in more detail regarding these other material weaknesses can easily obtain the previously issued reports in which they were identified and described.

3. Regarding the third area where comment was requested, we believe the standard should be modified to permit an auditor to report on the elimination of a material weakness that had been identified on an interim basis subsequent to the auditor's prior report. The Board has concluded (page 3 of the Release) that "it is appropriate to provide a mechanism to facilitate . . . assurance [by the company's independent auditor]." We feel that it would be inappropriate to preclude a company from providing such assurance solely due to the timing of the discovery of the material weakness. If a successor auditor can address weaknesses he or she had not previously reported upon (paragraph 23 of the proposed standard), then the continuing auditor should have the same opportunity. If the Board agrees with this recommendation, we believe the proposed standard should include guidance on the additional work that would be necessary to support the auditor's report.

Public Company Accounting Oversight Board
May 11, 2005
Page Two

We believe one additional issue should be considered by the Board prior to the final issuance of the proposed standard. The Board should require that the date of the assertion regarding the elimination of the material weakness coincide with the company's reporting date. Making the assertion date coincide with the company's reporting date eliminates any potential confusion on the part of readers regarding the impact of the material weakness on financial statements issued on a particular date. For example, if management's assertion regarding the elimination of a material weakness is dated April 5, a reader might question whether the first quarter's (as of 3/31/200X) financial information presented by the company was negatively impacted by the existence of the material weakness. If the assertion date and the company's reporting date coincide, the reader would be assured that the financial information reported on by the accountant was free of any impact on the material weakness. We believe this is consistent with Auditing Standard No. 2 where the assertion date and the accountant's reporting date are the same (for example, as of December 31, 200X).

We appreciate the opportunity to provide our input into the standard setting process.

Sincerely,

C. Jeff Gregg, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
42 WEST 44TH STREET
NEW YORK, NY 10036-6689

FINANCIAL REPORTING COMMITTEE

and

SECURITIES REGULATION COMMITTEE

May 12, 2005

Via email: comments@pcaobus.org

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

Attention: Office of the Secretary

Re: PCAOB Rulemaking Docket Matter No. 018

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Financial Reporting and the Committee on Securities Regulation of The Association of the Bar of the City of New York (the "Committee") in response to Release No. 2005-002 dated March 31, 2005 (the "Release"), in which the Public Company Accounting Oversight Board (the "PCAOB") announced a proposed Auditing Standard – Reporting on the Elimination of a Material Weakness (the “proposed standard” or “proposal”).

Our Committees are composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to major corporations, investment banks, and institutional investors.

Introduction

The Committees support the PCAOB’s objective of establishing requirements and providing direction that apply when an auditor is engaged to report on the elimination of a material weakness in internal control over financial reporting. In the initial application of the requirements of Section 404 of Sarbanes-Oxley, many companies have reported material weaknesses. Until a company is able to eliminate the material weakness and so inform investors and the financial community, there may be uncertainty about the reliability of the company’s financial statements. A company is required in its Quarterly Report on Form 10-Q to inform investors of changes in its internal control that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting. This will inform investors and the financial community of changes designed by management to eliminate a material weakness. The proposed standard will provide a valuable mechanism for auditors to confirm management's assertions that previously reported material weaknesses have been eliminated.

We suggest certain revisions to the proposal for consideration by the PCAOB. In addition, we believe the PCAOB should encourage successor auditors to accept engagements of the type envisioned by the proposed standard and clarify the procedures a successor auditor is expected to perform.

Permit an Auditor to Report on Post-Audit Material Weaknesses

We do not believe the proposed standard should be limited to material weaknesses previously described in an auditor's report issued pursuant to Auditing Standard No. 2. We believe the proposal should be revised to permit an auditor to report on the elimination of a material weakness that was identified and eliminated by a company as of an interim date. As indicated above, we believe that auditor reports on the elimination of a material weakness will provide important information to investors and the financial community about the reliability of a company's financial statements. The SEC's reporting requirements will require a company to include information on such a situation in a Quarterly Report on Form 10-Q. We see no need to require an auditor to wait until the next annual audit to assure those who rely upon the financial statements. We believe that the auditor should be able, on an interim basis, to evaluate management's assertion that the material weakness has been eliminated and perform the audit procedures necessary to determine that the controls specified in management's assertion were designed and operated effectively to eliminate the material weakness.

Engagement Acceptance by Successor Auditor

As indicated above, we believe that the proposed standard will provide an important mechanism to confirm management's assertions that previously reported material weaknesses have been eliminated, and therefore provide important information to investors, the financial community and others who rely upon a company's financial statements. In this initial period of the application of Sarbanes-Oxley Section 404 we believe this will be critical in restoring investor confidence in a company's financial statements. Therefore, we suggest the PCAOB review paragraphs 23 and 24 of the proposed standard in order to assure successor auditors that procedures necessary to obtain sufficient knowledge of the company's business and internal control over financial reporting will depend upon the nature of the material weakness, and that paragraph 24 is not intended to suggest that additional procedures are required or that a complete audit would be required except in extreme situations.

Conclusion

We commend the PCAOB for proposing a new standard of reporting on the elimination of a material weakness in internal control over financial reporting. It is the belief of the Committees that the public would be well served if the PCAOB gave additional consideration to specific elements of the proposed rule and considered our suggestions in connection with issuing staff guidance on Auditing Standard No. 2, as set forth in this letter.

Please note that this letter does not necessarily reflect the individual views of all members of the Committees.

Please note that Mark K. Schonfeld of the United States Securities and Exchange Commission, a member of the Association's Committee on Securities Regulation, did not participate in the preparation of this letter or the decision by the Committees to submit this letter to the PCAOB.

Members of the Committees would be pleased to answer any questions you might have regarding our comments, and to meet with the staff of the PCAOB if that would assist your efforts.

Respectfully Submitted,

/s/ N. Adele Hogan
N. Adele Hogan
Chair of Committee on Financial Reporting

/s/ Matthew J. Mallow
Matthew J. Mallow
Chair of Committee on Securities Regulation

Drafting Subcommittee

Martin M. Cohen
N. Adele Hogan
Rise B. Norman
Norman D. Slonaker

ABCNY COMMITTEE ON FINANCIAL REPORTING MEMBERSHIP

Not all of the Committee members participated in the preparation of this letter, nor did the participation of a member mean that he or she supported the views expressed in this letter. Moreover, the Committee members acted only as individuals and not as representatives of the organizations to which they belong or by which they are employed, and therefore the views expressed in the letter are not to be considered the views of any governmental, commercial or private organization other than the Association.

Bruce Bennett
Robert Buckholz
Wayne Carlin
Martin M. Cohen
Jill Darrow
Lou Dilorenzo
Richard Drucker
Steven Gartner
Caroline Gentile
Salvatore Graziano
William Hartnett
N. Adele Hogan, Chair
Raymond Hutcher
Kenneth Josselyn
Fred Knecht
Richard Kosnik
Raymond Lin
Peter Loughran
Michael Lubowitz
Aileen Meehan
Jeanne Mininall
Rise Norman
Stephen Older
Christopher Paci
Vincent Pisano
Neila Radin
Charles Raeburn
Bruce Rosenthal
Knute Salhus
Kathleen Shannon
Leslie Silverman
Norman Slonaker
Jill Wallach
John White
Michael Zuckert

ABCNY COMMITTEE ON SECURITIES REGULATION MEMBERSHIP

Not all of the Committee members participated in the preparation of this letter, nor did the participation of a member mean that he or she supported the views expressed in this letter. Moreover, the Committee members acted only as individuals and not as representatives of the organizations to which they belong or by which they are employed, and therefore the views expressed in the letter are not to be considered the views of any governmental, commercial or private organization other than the Association.

Matthew J. Mallow, Chair
Richard Aftanas, Secretary
Barbara L. Alexander
Lauren K. Boglivi
Paul A. Crotty
Robert W. Downes
Travis Epes
Stephen P. Farrell
Jill E. Fisch

Janet L. Fisher
Joel Stewart Forman
Merritt B. Fox
Stephen Fraidin
Michael I. Gans
Fraser L. Hunter
Kevin Keogh
Edward Kerson
Rosalind Fahey Kruse
Richard F. Langan, Jr.
W. Jeffrey Lawrence
Thomas Molner
James Odell
Robert F. Quaintance, Jr.
Arthur Robinson
Peter E. Ruhlin
Raphael M. Russo
Peter Safirstein
Mark K. Schonfeld
Brian Schorr
Vijay S. Tata
Roslyn Tom
William J. Whelan III
Robert Zuccaro

PCAOB
Public Company Accounting Oversight Board

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

REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST	PCAOB Release No. 2005-015 July 26, 2005 PCAOB Rulemaking Docket Matter No. 018

Summary: After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

Board Contacts: Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org), Sharon Virag, Assistant Chief Auditor (202/207-9164; virags@pcaobus.org)

* * *

I. Background

Congress enacted Section 404 of the Sarbanes Oxley Act of 2002 (the "Act") to provide investors with increased transparency about public companies' internal control over financial reporting. Since then, approximately 12.7 percent of public companies that are accelerated filers[1/] have reported that their internal control over financial

[1/] An "accelerated filer," as defined in Rule 12b-2 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2, is generally a U.S. company that, among other things, has equity market capitalization over $75 million and has filed at least one annual report with the Commission.

RELEASE

reporting is not effective because one or more material weaknesses in internal control over financial reporting existed as of the company's fiscal year-end.[2/] When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. They may also want information about the company's plans for remediating the material weakness and its timeframe for doing so, and to be notified when the material weakness has been eliminated. Thus, a disclosure that internal control over financial reporting is not effective is often only the beginning of a company's communications with investors concerning the material weakness (or weaknesses) that caused the problem.[3/]

Both companies and report users have recognized the importance of a mechanism for companies to effectively communicate with the markets when a previously reported material weakness in internal control over financial reporting no longer exists.[4/] In many cases, companies will find the mechanisms for company disclosures already provided by the federal securities laws sufficient. For example, a public company is required to disclose quarterly any changes in internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[5/] Investors will, therefore, learn of material improvements, such as the correction of a material weakness, on at

---

[2/] See Paul J. Martinek, Adjustments, Restatements Are Predictors Of Weaknesses, Compliance Week (June 14, 2005).

[3/] Some companies with material weaknesses have already begun this process by including detailed descriptions of their remediation plans in their annual filings or by providing additional disclosures in subsequent filings on the steps they are continuing to take to remediate the weaknesses. See June 2005 Internal Control Report: All About Remediation, Compliance Week (July 6, 2005).

[4/] 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 ("SAG Meeting"). An archived webcast of the SAG Meeting and a related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the PCAOB's Web site at www.pcaobus.org.

[5/] See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

RELEASE

least a quarterly basis through these required disclosures.[6/] Under the Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements*, the company's auditor is responsible for evaluating these quarterly disclosures.[7/] Finally, investors will also learn about the status of previously reported material weaknesses (as well as internal control over financial reporting overall), accompanied by auditor assurance, when the company files its next annual report. Investors and issuers, however, have called for the ability to obtain auditor assurance as of an interim date that a previously reported material weakness no longer exists. At the November 18, 2004, SAG Meeting, several members of the group with experience as investors and issuers encouraged the Board to develop a standard that would describe this type of engagement for the auditor. In particular, several issuer members of the SAG emphasized that companies that have reported a material weakness will want to have options available to assure the markets that the material weakness has been remediated.[8/]

II. Public Comment on the Board's Proposal

On March 31, 2005, the Board issued for public comment a proposed auditing standard titled "Reporting on the Elimination of a Material Weakness." In response, the Board received 30 comment letters from a variety of interested parties, including auditors, investors, issuers, and others. The comment letters included detailed

---

[6/] Of course, through this same mechanism, investors also could learn if internal control over financial reporting deteriorates materially during the year.

[7/] See Paragraphs 202-206 of Auditing Standard No. 2, as well as PCAOB Staff Question and Answer No. 55 regarding the extent of these responsibilities. The Staff Questions and Answers are available on the Board's Web site under Standards at www.pcaobus.org.

[8/] See Nick S. Cyprus, Vice President, Controller and Chief Accounting Officer, The Interpublic Group of Companies, Remarks at SAG Meeting (Nov. 18, 2004) ("I guarantee there will be demand [for such a standard]"); Sam Cotterell, Vice President and Controller, Boise Cascade LLC, Remarks at SAG Meeting (Nov. 18, 2004) ("if I have a material weakness disclosed, I want a mechanism to let the market know that that has been fixed. I want to do that as quickly as possible.").

RELEASE

discussion of a wide range of topics. Many commenters expressed strong support for the standard.[9/]

Other comments included:

- suggestions regarding the wording of the auditor's opinion and the title of the proposed standard;
- discussion of several technical issues, such as the standard's focus on control objectives, consideration of materiality, and the potential need for the auditor to perform substantive procedures;
- suggestions regarding the auditor's responsibility when new material weaknesses are identified during this engagement, and when all previously reported material weaknesses are not being reported upon by the auditor;
- concerns that, although an engagement under the standard would be completely voluntary, it could become compulsory, as a practical matter, if investors begin to insist on auditor attestation in all cases in which a material weakness is identified;
- a suggestion that the conforming amendment be modified to allow auditors to use AT 101 strictly for a company's internal use.

The Board carefully considered all of the comment letters that it received. A detailed analysis of comments and the Board's responses are contained in the Background and Basis for Conclusions, in Appendix B of the standard.

[9/] See Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to J. Gordon Seymour, Acting Secretary, PCAOB (Apr. 15, 2005) ("The elimination of a material weakness, accompanied by an independent auditor's interim report attesting to management's assessment of its internal controls, will increase investor confidence in the reliability of a company's financial statements."); Letter from Gregory J. Jonas, Managing Director, Moody's Investors Service, to Office of the Secretary, PCAOB (May 5, 2005) ("the proposed standard strikes a useful balance by giving companies the option to provide users with information they value and with the assurance they find useful while not requiring a complete re-assessment").

RELEASE

III. Summary of Changes to the Proposed Standard

The Board adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, after making several changes to the proposed standard in response to comments. The more significant changes include –

- revising the form of the auditor's opinion to clarify that the purpose of the engagement is to determine whether the material weakness "exists" or "no longer exists" and making related changes to the title of the standard;

- conforming text in the conditions for engagement performance to the text of a parallel provision in PCAOB Auditing Standard No. 2, due to the close relationship between the two standards. Specifically, the Board clarified that under Auditing Standard No. 4, management's evidence includes documentation;

- adding guidance on the subjects of materiality, control objectives and substantive procedures;

- adding a responsibility for the auditor to inform the audit committee if the auditor identifies a new material weakness during an engagement performed under this standard;

- modifying the required elements of the auditor's report to clarify that a continuing auditor previously obtained an understanding of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness;

- including additional illustrative auditor's reports; and

- modifying the conforming amendment to the Board's interim attestation standards to allow auditors to continue to use AT 101 for engagements to report on whether a material weakness continues to exist if such a report is intended strictly for a company's internal use.

These changes have been reflected in the adopted standard, and are discussed further in the Background and Basis for Conclusions, included in Appendix B of the standard.

RELEASE

IV. Overview of the Engagement

This standard establishes a stand-alone engagement that is entirely voluntary, performed only at the company's request. This type of reporting is not required by the Act or the standards or rules of the PCAOB, and should not be viewed as compulsory. The Board anticipates that in deciding whether to engage their auditors to report on whether a particular material weakness continues to exist, companies will weigh the costs and benefits and do so only when it is cost-effective. Based on the investor and issuer comments at the SAG Meeting, the Board believes that, in some situations, companies will find that auditor assurance that a material weakness no longer exists leads to a higher level of investor confidence in a company's financial reporting, and that the costs of the engagement are therefore worth incurring. If a company believes, however, that these benefits would be outweighed in a particular case by the costs of obtaining them, the company may (and presumably would) determine not to engage its auditor to perform this work.

Although the Board designed this standard to be a cost-effective means of providing investors assurance that a material weakness no longer exists, the Board expects that this engagement will be best suited and most cost-effective for reporting on material weaknesses that are discrete problems with a limited effect on the company's internal control over financial reporting. Reporting on material weaknesses that have a pervasive effect on the company's internal control over financial reporting could require such a broad and extensive base of work that the Board anticipates that a company in this situation would choose to wait for the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2 to obtain auditor assurance that a pervasive material weakness no longer exists.

The objective of an auditor's engagement under this standard is to express an opinion on whether a previously reported material weakness continues to exist. The standard, therefore, draws from many concepts applicable to the auditor's report on the effectiveness of internal control over financial reporting, as described in Auditing Standard No. 2, although in a more narrowly focused and limited manner. For this reason, most of the requirements in the standard will be familiar to auditors. In designing this standard, the Board provided flexibility wherever possible, to allow auditors to conduct the engagement in a manner suited to the material weakness in internal control over financial reporting at issue.

Similar to any other attestation service, an auditor's report under this standard is based on an evaluation of management's assertion that the material weakness no longer exists. This standard establishes several conditions that must be met for the auditor to perform this engagement. These conditions were patterned after management's responsibilities under the SEC's rules implementing Section 404 of the Act[10/] and the corresponding conditions in Auditing Standard No. 2.[11/] These conditions include management accepting responsibility for internal control over financial reporting, evaluating the effectiveness of the specified controls that address the material weakness, asserting that the specified controls are effective in addressing the material weakness, and supporting its assertion with sufficient evidence, including documentation.

The auditor's assurance resulting from this engagement is that the previously reported material weakness, in the auditor's opinion, no longer exists as of a specified date. Although the auditor's evaluation of the design and operating effectiveness of the identified controls generally follows the requirements of PCAOB Auditing Standard No. 2, this engagement is designed to be significantly narrower in scope because the auditor's testing is limited to the controls specifically identified by management as addressing the material weakness. Both management and the auditor use the company's stated control objective as the target for determining whether the specified controls sufficiently address the material weakness. (See Section VI for further discussion of the determination that a material weakness no longer exists.)

V. Auditor's Report

To communicate clearly the narrow focus of this engagement, the standard requires the auditor's report to describe the material weakness, identify all of the specified controls that management asserts address the material weakness, and identify the stated control objective achieved by these controls. The report also is required 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.[12/] Report users should thus understand the limited scope of the auditor's opinion.

10/ See Item 308(a) of Regulation S-K, 17 C.F.R. § 229.308(a).

11/ See Paragraph 20 of Auditing Standard No. 2.

12/ The SAG Meeting included a discussion about the importance of such a report clearly communicating to report users the scope of the engagement. Several SAG members emphasized the potential for report users to believe, mistakenly, that the

RELEASE

To render an opinion that a material weakness no longer exists, the auditor must have obtained evidence about the design and operation of the relevant controls, determined that the material weakness no longer exists, and determined that no scope limitations were placed on the auditor's work. Because of the narrow focus of this engagement, qualified opinions are not permitted. Limitations on the scope of the auditor's work preclude the auditor from rendering an opinion. The auditor's opinion as to whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Accordingly, the standard does not distinguish between an unqualified opinion and an adverse opinion but simply refers to the auditor's opinion.

Unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The "as of" date of management's assertion represents the day the company believes the material weakness no longer exists and that the company has adequately assessed the effectiveness of the specified controls that address the material weakness. In the event that the auditor begins testing and concludes that additional remediation is required to address the material weakness, the company has the opportunity to re-address its remediation efforts, reset the assertion date, and ask the auditor again to opine on whether the material weakness continues to exist.

If the auditor determines that a material weakness continues to exist and does not issue a report, the standard requires the auditor to communicate to the company's audit committee, in writing, his or her conclusion that the material weakness continues to exist. Similarly, the auditor also has a responsibility to communicate to the audit committee, in writing, any new material weaknesses that the auditor identifies during this engagement that the auditor has not already communicated in writing to the audit committee. The standard also addresses the circumstance in which the auditor reports on fewer than all of the previously reported material weaknesses. In this circumstance, the standard requires the auditor to include language in his or her report stating that his or her previously issued report on management's annual assessment of the company's internal control over financial reporting identified additional material weaknesses, that the auditor is not reporting on those other material weaknesses, and that the auditor,

---

auditor, as a result of this limited engagement, had rendered a current opinion regarding the effectiveness of internal control over financial reporting overall. Comments received on the proposed standard generally expressed overall support for the clarity of the proposed auditor's report in this regard.

RELEASE

accordingly, is expressing no opinion on whether those material weaknesses exist after the company's year-end.[13/]

VI. Determining that a Material Weakness No Longer Exists

The standard requires the auditor to obtain evidence sufficient to determine whether the design and operation of the controls identified by management achieve the *stated control objectives* and that the material weakness no longer exists. 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.[14/] A stated control objective in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. For this reason, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

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 may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment is an example of this situation. 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 tested, instead, during the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

[13/] Several investors, among others, suggested that, in the circumstance in which additional material weaknesses were previously reported but are not the subject of the auditor's report on whether a material weakness continues to exist, the auditor's report should draw attention to these other material weaknesses. In response to these comments, the standard states that when referring to his or her previously issued report, the auditor is required either to attach that report to his or her report on whether the material weakness continues to exist or to include information about where the previously issued report can be publicly obtained.

[14/] See Paragraphs 68 through 70 of Auditing Standard No. 2 for additional information on relevant assertions.

RELEASE

VII. Using the Work of Others

Auditing Standard No. 4 applies the same framework for using the work of others as the one described in Auditing Standard No. 2. Similar to Auditing Standard No. 2, the standard permits the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of work related to this engagement. 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 persons performing the work.

Under both Auditing Standard No. 2 and this standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. Under 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. Under this standard, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion needs to be applied at the control objective level. It should be noted, however, that this does not require the auditor to obtain the principal evidence that each control specifically identified in management's assertion as related to the identified control objectives is effective.

There may be some circumstances in which the scope of the audit procedures to be performed in this type of engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The flexibility that the framework otherwise provides, however, is meant to encourage auditors to evaluate whether opportunities exist to use the work of others in this context.

VIII. Effective Date of the Standard

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

RELEASE

*   *   *

On the 26th day of July, 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

July 26, 2005

APPENDICES –

1 – Auditing Standard No. 4 – *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

2 – Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of Auditing Standard No. 4 – *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

PCAOB
Public Company Accounting Oversight Board

PCAOB Release 2005-015
July 26, 2005
Page A1–1 – Standard

RELEASE

Appendix 1 – Auditing Standard No. 4

Auditing Standard No. 4 –

REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST

PCAOB
Public Company Accounting Oversight Board

PCAOB Release 2005-015
July 26, 2005
Page A1–2 – Standard

RELEASE

Table of Contents

RELEASE

RELEASE

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard – *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Applicability of Standard

1. This standard establishes requirements and provides direction that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting (hereinafter referred to as a material weakness) continues to exist as of a date specified by management.

> Note 1: In this context, *previously reported material weakness* means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.
>
> Note 2: The date specified by management as the date that the previously reported material weakness no longer exists must be a date after the date of management's most recent annual assessment.

2. An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist 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*, as of the date of the company's most recent annual assessment of internal control over financial reporting, 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 26 of this standard for additional requirements that apply specifically to a successor auditor's application of this standard.)

> Note: References in this standard to the company's most recent annual assessment of internal control over financial reporting apply to the company's most recent assessment of internal control over financial reporting overall, either

as of the company's year-end or as of a more recent interim date, as audited by the auditor in accordance with Auditing Standard No. 2.

3. The auditor may report on more than one previously reported material weakness as part of a single engagement.

4. 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 whether a previously reported material weakness continues to exist. 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.

Auditor's Objective in an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

5. The auditor's objective in an engagement to report on whether a previously reported material weakness continues to exist is to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon. The auditor's opinion relates to the existence 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.

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 a material weakness continues to exist.

Conditions for Engagement Performance

7. The auditor may report on whether a previously reported material weakness continues to exist at a company only if all of the following conditions are 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 addresses the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and management's stated control objective(s);

c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

d. Management supports its assertion with sufficient evidence, including documentation; and

e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 48 of this standard.

8. If all the conditions in paragraph 7 of this standard are not met, the auditor is not permitted to complete the engagement to report on whether a previously reported material weakness continues to exist.

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 whether a previously reported material weakness continues to exist, both management and the auditor must use both (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 continues to exist.

RELEASE

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.*)

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 states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement to or omission in that relevant assertion is prevented or detected by controls on a timely basis.[1/]

12. 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.

13. In an audit of internal control over financial reporting, the auditor is required to identify the company's control objectives in each area and to identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.[2/]

[1/] See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

[2/] See paragraph 88 of Auditing Standard No. 2.

14. 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

15. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved.

16. A *stated control objective* in the context of an engagement to report on whether a material weakness continues to exist is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing.

RELEASE

17. Because the stated control objective, for purposes of this engagement, provides management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

> Note: When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the related control objectives that are not being achieved may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment would be an example of this circumstance. If management and the auditor have difficulty identifying *all* of the stated control objectives affected by a material weakness, the material weakness probably is not suitable for this engagement and should be addressed, instead, through the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

Performing an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

18. In an engagement to report on whether a previously reported material weakness continues to exist, 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 1: 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.

> Note 2: 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, the auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

RELEASE

Applying the Standards of the PCAOB

19. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on whether a previously reported material weakness continues to exist. Adherence to the standards involves:

a. Planning the engagement,

b. Obtaining an understanding of internal control over financial reporting,

c. Testing and evaluating whether a material weakness continues to exist, including using the work of others, and

d. Forming an opinion on whether a previously reported material weakness continues to exist.

20. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing whether a previously reported material weakness continues to exist involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section of the standard concurrently.

21. The engagement to report on whether a previously reported material weakness continues to exist 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.

22. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on whether a previously reported material weakness continues to exist.

23. 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 whether a previously reported material weakness continues to exist. Therefore, the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness

RELEASE

exists. The auditor should assess materiality as of the date that management asserts that the previously reported material weakness no longer exists.

Planning the Engagement

24. The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise any assistants. When planning the engagement, 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

25. To perform this engagement, 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 in accordance with Auditing Standard No. 2 as of the date of the company's most recent annual assessment of internal control over financial reporting would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement.

> Note: The second sentence of the paragraph above 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 financial reporting as of the company's most recent year-end or more recently, then that auditor should follow the requirements for a successor auditor in paragraphs 26a-b and 27. 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 26 and 27 for a successor auditor.

RELEASE

26. When a successor auditor[3/] performs an engagement to report on whether a previously reported material weakness continues to exist and he or she has not yet completed an audit of internal control over financial reporting at the company, he or she must perform procedures to obtain sufficient knowledge of the company's business and its internal control over financial reporting to achieve the objective of the engagement, as described in paragraph 5 of this standard. 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 whether a previously reported material weakness continues to exist 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 addressing the material weakness.

> 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. The auditor need not perform a walkthrough of major classes of transactions that are affected only indirectly by the controls specifically identified by management as addressing the material weakness.

[3/] 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*.

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 address that material weakness.

27. A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 26 of this standard 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 whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Testing and Evaluating Whether a Material Weakness Continues to Exist

28. 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 no longer exists. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on whether a previously reported material weakness continues to exist, because one of the conditions for engagement completion described in paragraph 7 of this standard 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 management's evidence supporting management's assertion that a previously reported material weakness no longer exists.

29. As a part of evaluating management's evidence supporting its assertion, the auditor should determine whether management has selected an appropriate date for its

RELEASE

assertion. In making this determination, the auditor should take into consideration the following:

a. Management's assertion that a previously reported material weakness no longer exists 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.

30. 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 whether a previously reported material weakness continues to exist will 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.

31. All controls that are necessary to achieve the stated control objective(s) should, therefore, be specifically identified and evaluated. The specified controls will necessarily include controls that have been modified or newly implemented and also may include existing controls that previously were deemed effective during management's most recent annual assessment of internal control over financial reporting. As part of testing and evaluating the design effectiveness of the specified controls, the auditor should determine whether the specified controls would meet the

RELEASE

stated control objective(s) if they operated as designed. In making this evaluation, the auditor should apply paragraphs 88 through 91 of Auditing Standard No. 2.

32. 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.

33. 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 whether a previously reported material weakness continues to exist. 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. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

34. The auditor should determine whether, based on the nature of the material weakness, 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. For example, a material weakness in the company's controls over the calculation of its bad debt reserve ordinarily would require that the auditor also perform substantive procedures to obtain sufficient evidence supporting an opinion about whether the material weakness continues to exist as of a specified date. In this circumstance, in

addition to testing the design and operating effectiveness of the controls specifically identified as achieving the company's stated control objective that its bad debt reserve is reasonably estimated and recorded, the auditor ordinarily would need to perform substantive procedures to determine that, as of that same specified date, the company's bad debt reserve was fairly stated in relation to the company's financial statements taken as a whole.

35. 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.

Using the Work of Others

36. The auditor should evaluate whether to use the work performed by others in an engagement to report on whether a previously reported material weakness continues to exist. 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 otherwise would have performed, the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2.

37. The auditor's opinion relates to whether a material weakness no longer exists at the company because the stated control objective(s) is 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 that the control objectives related to each of the material weaknesses identified in management's assertion are achieved. 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 provide information about the effectiveness of internal control over financial reporting.

38. Paragraph 122 of Auditing Standard No. 2 should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. 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." There may, therefore, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited

that using the work of others will not provide any tangible benefit to the company or its auditor. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

> Note: The requirement described in paragraph 26b of this standard for the auditor to perform a walkthrough applies only to an auditor who did not complete an audit of internal control over financial reporting as of the company's most recent annual assessment. An auditor who has rendered an opinion on the effectiveness of the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment is not required to perform a walkthrough as part of this engagement.

39. The following example illustrates how to apply this section on using the work of others to this engagement.

> 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.

> Although certain 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 tests of controls that are centralized at the holding company level 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 no longer exists. 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 due to 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 supporting an opinion on the much narrower subject of whether a specified material weakness in internal control over financial reporting continues to exist, the examples in Auditing Standard No. 2 may not illustrate the appropriate application of using the work of others in this narrower engagement. For instance, 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. However, in most cases, the auditor could not solely use the work of others for a control specified in management's assertion regarding a material weakness no longer existing 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 is applicable only in the context of a recurring engagement, which is not the context for the auditor's reporting on whether a previously reported material weakness continues to exist.

Opinions, Based in Part, on the Work of Another Auditor

40. 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 whether a previously reported material weakness continues to exist, with the following exception. If the auditor decides to serve as the principal auditor and to 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 Whether a Previously Reported Material Weakness Continues to Exist

41. When forming an opinion on whether a previously reported material weakness continues to exist, 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.

42. Management may conclude that a previously reported material weakness no longer exists because it has been reduced to a significant deficiency. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. Under paragraph 140 of Auditing Standard No. 2, a significant deficiency not corrected after some reasonable period of time is a strong indicator of a material weakness. Because the auditor is not required to provide an opinion under this voluntary engagement, the auditor could reasonably decline to provide an opinion under such circumstances.

43. The auditor may issue an opinion on whether a previously reported material weakness continues to exist only when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on whether a previously reported material weakness continues to exist, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement. A qualified opinion is not permitted.

> Note: As described in paragraph 51 of this standard, the auditor's opinion on whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Therefore, the provisions of this standard do not distinguish between an unqualified opinion and an adverse opinion and, instead, refer simply to "an opinion" or "the auditor's opinion."

RELEASE

Requirement for Written Representations

44. In an engagement to report on whether a previously reported material weakness continues to exist, 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 management's 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 no longer exists 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 that has occurred or come to management’s attention since the date of management's most recent annual assessment of 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 indicate that the identified controls were not operating effectively as of, or subsequent to, the date specified in management's assertion.

45. The written representations should be signed by those members of management with overall responsibility for the company's internal control over financial reporting whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management ordinarily include the chief executive officer and chief financial officer or others with equivalent positions in the company.

RELEASE

46. 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 43 of this standard, if there is a limitation on the scope of an engagement to report on whether a previously reported material weakness continues to exist, 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.

Documentation Requirements

47. The documentation requirements in Auditing Standard No. 3, *Audit Documentation*, 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 29 of this standard, management's assertion that a material weakness no longer exists may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on whether a previously reported material weakness continues to exist may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on whether a previously reported material weakness continues to exist, 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 whether a previously reported material weakness continues to exist.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Management's Report

48. 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 of this standard. 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;

RELEASE

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;

> 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 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 no longer exists as of the same specified date because the specified controls address the material weakness.

Auditor's Evaluation of Management's Report

49. 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.

50. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 48 of this standard, the conditions for engagement performance have not been met.

RELEASE

Auditor's Report

51. The auditor's report on whether a previously reported material weakness continues to exist must include the following elements:

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

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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should refer to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness.

c. A description of the material weakness;

d. An identification of management's assertion that the identified material weakness in internal control over financial reporting no longer exists;

e. An identification of the management report that includes management's assertion, such as identifying the title of the report (if the report is titled);

f. A statement that management is responsible for its assertion;

g. An identification of the specific controls that management asserts address the material weakness;

> Note: As discussed further in paragraph 31, all controls that are necessary to achieve the stated control objective should be identified.

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 whether the material weakness continues to exist as of the date of management's assertion 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);

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 a previously reported material weakness continues to exist at the company;

l. A statement that the engagement includes examining evidence supporting management's assertion and performing such other procedures the auditor considered necessary in the circumstances and that the auditor obtained an understanding of internal control over financial reporting as part of his or her previous audit of management's annual assessment of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness;

> Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should include 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 exists (or no longer exists) 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 occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2 to read as follows: That the auditor has not 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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.

52. Example A-1 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists, expressed by an auditor who has previously reported on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent year-end (herein after referred to as a continuing auditor). Example A-2 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists expressed by a successor auditor.

53. As stated in paragraph 3 of this standard, the auditor may report on more than one previously reported material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 51 of this standard accordingly.

54. *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 56 of this standard.)

b. A significant subsequent event has occurred since the date being reported on. (See paragraphs 57 and 58 of this standard.)

c. Management's report on whether a material weakness continues to exist includes additional information. (See paragraphs 59 through 60 of this standard.)

55. As described further in paragraph 43 of this standard, the form of the auditor's report resulting from an engagement to report on whether a previously reported material weakness continues to exist may be an opinion on whether a material weakness continues to exist, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. 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 whether a material weakness continues to exist and, instead, withdraw from the engagement.

RELEASE

56. *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 whether any or all of the material weaknesses continue to exist. 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. When referring to his or her previously issued report on management's annual assessment, the auditor should either attach that report or include information about where it can be publicly obtained.

> Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording and references or attachments appropriately for use in a successor auditor's report.*]

Example A-3 in Appendix A is an illustrative report issued by a continuing auditor reporting on only one material weakness when additional material weaknesses previously were reported.

57. *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 44 of this standard, 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 relevant to the stated control objective or identified controls;

- Regulatory agency reports on the company's internal control over financial reporting relevant to the stated control objective or identified controls; and

- Information about the effectiveness of the company's internal control over financial reporting relevant to the stated control objective or identified controls obtained as a result of other engagements.

58. 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 61 regarding special considerations when a material weakness continues to exist. 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.

59. *Management's report includes additional information*. If management's report includes information in addition to the matters described in paragraph 48 of this standard, 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.

60. 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 59 outside its report on whether a previously reported material weakness continues

to exist and includes them elsewhere within a document that contains management's and the auditor's reports on whether a previously reported material weakness continues to exist, the auditor would not need to disclaim an opinion, as described in paragraph 59. 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.

Special Considerations When a Previously Reported Material Weakness Continues to Exist

61. If the auditor determines that the previously reported material weakness continues to exist and the auditor reports on the results of the engagement, he or she must express an opinion that the material weakness exists as of the date specified by management.

62. As described in paragraph 55, the auditor is not required to issue a report as a result of this engagement. If the auditor does not issue a report in this circumstance, he or she must communicate, in writing, his or her conclusion that the material weakness continues to exist to the audit committee. Similarly, if the auditor identifies a material weakness during this engagement that has not been previously communicated to the audit committee in writing, the auditor must communicate that material weakness, in writing, to the audit committee.

63. Additionally, whenever the auditor concludes that a previously reported material weakness continues to exist, 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

64. For example, if the auditor were engaged to report on whether two separate material weaknesses continue to exist and concluded that one no longer exists and one continues to exist, the auditor's report could comprise either of the following: (1) a report that contained two opinions, one on the material weakness that the auditor concluded no longer exists and one opinion on the material weakness that the auditor concluded continues to exist, or (2) a report that contained only a single opinion on the material weakness that the auditor concluded no longer exists if the company modifies its assertion to address only the material weakness that the auditor concluded no longer exists. In the second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness continues to exist to the audit committee and also should apply paragraph 56 of this standard regarding other material weaknesses

reported 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 required by paragraphs 202 through 206 of Auditing Standard No. 2.

Effective Date

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

PCAOB Release 2005-015
July 26, 2005
Page A1–31 – Standard

RELEASE

Appendix A – Illustrative Reports on Whether a Previously Reported Material Weakness Continues to Exist

Paragraphs 51 through 60 of this standard provide direction on the auditor's report on whether a previously reported material weakness continues to exist. The following examples illustrate the application of those paragraphs.

Example A-1—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-2—*Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-3—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported*

RELEASE

Example A-1

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and

RELEASE

performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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 the effectiveness of specific controls or internal control over financial reporting overall 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

Example A-2

ILLUSTRATIVE AUDITOR'S REPORT FOR A SUCCESSOR AUDITOR EXPRESSING AN OPINION THAT A PREVIOUSLY REPORTED MATERIAL WEAKNESS NO LONGER EXISTS

Report of Independent Registered Public Accounting Firm

We were engaged to report on whether a previously reported material weakness continues to exist at XYZ Company as of [*date of management's assertion*] and to audit management's next annual assessment of XYZ Company's internal control over financial reporting. Another auditor 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)."*]. The other auditor's report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] 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 a previously reported material weakness continues to exist at the company. 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, the material weakness described above no longer exists 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 other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall 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

Example A-3

ILLUSTRATIVE AUDITOR'S REPORT FOR A CONTINUING AUDITOR EXPRESSING AN OPINION ON ONLY ONE PREVIOUSLY REPORTED MATERIAL WEAKNESS WHEN ADDITIONAL MATERIAL WEAKNESSES PREVIOUSLY WERE REPORTED

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 audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above 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 whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

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 a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists 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. Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., 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 the effectiveness of specific controls or internal control over financial reporting overall 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*]

PCAOB Release 2005-015
July 26, 2005
Page A1–38 – Standard

RELEASE

APPENDIX B

BACKGROUND AND BASIS FOR CONCLUSIONS

Table of Contents — ***Paragraph***

RELEASE

Introduction

B1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and not accepting others.

Background

B2. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the Securities and Exchange Commission's (the "SEC" or "Commission") implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

B3. When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists.[1/] The federal securities laws provide part of that mechanism. Those laws require the company to disclose to investors any changes in internal control over financial reporting 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

[1/] 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. The webcast of the November 18, 2004 SAG discussion and the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the Board's Web site at www.pcaobus.org.

reporting.[2/] Therefore, investors will learn of material improvements, such as the remediation of a material weakness, on a timely basis through quarterly disclosures.[3/]

B4. When a company determines that a material weakness has been remediated, it may determine that disclosure is sufficient. Some 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.[4/]

B5. 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 provide requirements for general attest engagements; however, the Board determined that these standards lack sufficient specificity for this purpose.[5/] The Board, therefore, proposed an auditing standard that

---

[2/] See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

[3/] 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 materially during the year through these quarterly disclosures.

[4/] The Standing Advisory Group's November 18, 2004 discussion included this type of encouragement.

[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 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 interim standards are available on the Board's Web site at www.pcaobus.org.

would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

B6. The Board received 30 comment letters on its proposal, primarily from auditor and investor groups as well as from two issuers. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Voluntary Nature of Engagement

B7. The proposed standard explicitly stated that the engagement described by this standard is voluntary and that the standards of the PCAOB did not require an auditor to undertake this engagement when a material weakness was previously reported. In addition, the Board stressed the voluntary nature of this engagement at the public meeting proposing this standard.

B8. The value and importance of the Board's standards providing the option of this type of auditor reporting on a material weakness was confirmed unanimously in the comment letters from investors and investor-related parties. Auditors were also supportive of the standard overall and its voluntary nature. Both of the issuers who commented indicated that they would be concerned if issuers become compelled to obtain such opinions. One of these commenters stressed that the disclosure requirements of management, coupled with enhanced criminal penalties, should provide investors with information regarding the continued existence or correction of a material weakness.

B9. The Board continues to believe that providing for this type of auditor reporting in its standards will serve the public interest. At the same time, the Board reaffirms that reporting on whether a material weakness continues to exist is a voluntary engagement and is not required by the standards of the PCAOB.

RELEASE

Form of the Auditor's Opinion

B10. The proposed standard called for the auditor to express a single opinion directly on the subject matter (i.e., the material weakness itself), rather than on management's assertion, as follows:

> 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*].

B11. Primarily auditors commented on the form of the opinion in the proposed standard and their comments reflected a wide spectrum of ideas. Some commenters expressed support for the auditor's report, including the form of the opinion as proposed. Other comments included a suggestion for two opinions, consistent with Auditing Standard No. 2—one on the subject matter (the elimination of the material weakness) and one on management's assertion. Other commenters suggested that just one opinion was sufficient, though these commenters were split regarding whether the one opinion should be on management's assertion or on the subject matter. Other commenters suggested that an opinion stating that the material weakness had been eliminated, without the phrase "because the stated control objective is met" would be a better alternative, while others asked the Board to consider an opinion stating that the identified controls were effective because the stated control objective was met, without stating that the material weakness had been eliminated.

B12. A number of commenters expressed concern with the phrasing "the material weakness has been eliminated," including the use of that phrase in the auditor's opinion and in the title of the proposed standard. These commenters believed that terminology such as "elimination" or "eliminated" might be too definite a term that might mislead report users into believing that there were no remaining deficiencies in the internal control over financial reporting in the area related to the specified material weakness, even though control deficiencies of a lesser severity than a material weakness might persist.

B13. After considering these suggestions, the Board decided to retain a single opinion on the subject matter and to revise the opinion wording. The Board continues to believe that a single opinion expressed directly on the subject matter is the simplest and clearest form of communication related to this engagement. Further, the Board believes that an auditor's opinion directly on the subject matter (i.e., the material weakness itself) will best achieve the overarching objective of this engagement—to clearly communicate

RELEASE

as of an interim date auditor assurance about whether a previously reported material weakness continues to exist.

B14. The Board agreed with commenters that use of the term "elimination" might increase the risk that a report user would misunderstand the assurance provided by an auditor's opinion on a previously reported material weakness. As a result, the Board changed the form of the opinion to "In our opinion, the material weakness described above no longer exists as of [date of management's assertion]" and the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist." The text of the standard was modified throughout to delete references to "eliminated" or "elimination" and to reflect wording consistent with the revised opinion and title.

As-of Date of Report

B15. The proposed standard provided for significant flexibility by allowing the engagement to be undertaken at any time during the year, limited only by implications associated with the nature of the material weakness. In other words, the proposed standard did not require the engagement to be performed in conjunction with an audit or review of financial statements. Instead, the proposed standard required the auditor to determine whether management had selected an appropriate date for its assertion and specified several matters for the auditor to consider in making this determination.

B16. A number of auditors suggested that the engagement described by the proposed standard should be performed only as of quarterly financial reporting dates instead of as of any date during the year. These commenters believed that such a requirement would allow the auditor to integrate this work with the auditor's interim review procedures under AU sec. 722, *Interim Financial Information*, and provide a link between the auditor's report on the material weakness and management's quarterly disclosures of material changes in internal control. Commenters noted that many of the material weaknesses that have been disclosed to date are related to the period-end financial reporting process and that the auditor would therefore need to test controls in connection with a period-end to determine whether the material weakness continues to exist. Several commenters linked their suggestion that this engagement be performed only as of a quarterly financial reporting date to the view that the standard's direction on performing substantive procedures as part of this engagement should be bolstered (see separate discussion on performance of substantive procedures beginning at paragraph B51). One commenter pointed out, however, that if this engagement could be conducted only in connection with a quarterly financial reporting date, special guidance for applying the standard to foreign filers would be necessary because foreign filers are not required to report quarterly in the same manner as domestic filers.

B17. The Board believes that the flexibility provided in the proposed standard regarding the timing of the engagement is an important and appropriate feature of the standard. Although the Board agrees with commenters' observations that many of the material weaknesses disclosed during the past year were related to the period-end financial reporting process, the Board determined that the existing provisions of the proposed standard address this circumstance. In determining whether management has selected an appropriate date for its assessment, the standard requires the auditor to consider that controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

B18. Moreover, some material weaknesses—such as those that involve transaction-based controls that operate daily—are well suited for a management assertion and an auditor opinion that the material weakness no longer exists as of almost any date. Restricting an auditor's reporting on whether a material weakness continues to exist to only quarterly financial reporting dates could impose unnecessary delay on a company seeking auditor assurance that this type of material weakness no longer exists. For example, assume that a calendar year-end company had previously disclosed a material weakness that was the type that would lend itself well to reporting that it no longer existed as of any date. Further, management could not yet assert that the material weakness no longer existed as of March 31, but believed that it could make the assertion as of a date in April. If the standard restricted auditor reporting to a quarterly financial reporting date, the auditor would have to wait until June 30 to be able to attest to whether the material weakness continued to exist (and, presumably, would not be able to issue his or her report until July, at the earliest). While management could, in this example, provide timely disclosure to investors that the material weakness no longer existed, the Board concluded that structuring the provisions of the standard to potentially result in this kind of delay in auditor assurance would not serve the public interest.

B19. In light of these considerations, the Board decided to retain the provisions of the proposed standard that would permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B20. At least one auditor asked for clarification about whether a report issued pursuant to Auditing Standard No. 2 that identified a material weakness could be issued at the same time as a report pursuant to this standard indicating that the material weakness no longer exists as of a later date. The degree of flexibility regarding the timing of this engagement would permit the company (depending on the company's ability to assert that a material weakness no longer exists and the auditor's ability to timely audit that assertion) to simultaneously distribute its annual reports and the management assertion and auditor report described in this standard. Consistent with this flexible approach, nothing in this standard or Auditing Standard No. 2 would preclude the auditor from issuing a single, combined report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2 and the results of an engagement performed pursuant to this standard.

Applicability of the Standard to Material Weaknesses Not Previously Reported

B21. The proposed standard was structured to allow an auditor to report only on a previously reported material weakness. The proposed standard defined a previously reported material weakness as a material weakness that was previously described by an auditor's report issued pursuant to Auditing Standard No. 2. A material weakness initially identified *after* the company's annual assessment date could not, therefore, be the subject of an auditor's report under the proposed standard.

B22. Virtually all of the investors who submitted comment letters suggested that the standard should allow for auditor reporting on material weaknesses identified subsequent to the company's most recent annual assessment of internal control over financial reporting. Although some of these commenters expressed concern about the level of work that might be required of the auditor to thoroughly understand a material weakness not previously reported upon by an auditor, they did not believe that the standard should prohibit such reporting. One commenter stated that if a successor auditor could gain an understanding of a company's internal control sufficient to report on a material weakness that was identified and reported on by a predecessor auditor, an auditor should be able to gain the understanding necessary to report on a material weakness identified by management as of an interim date.

B23. The majority of the auditors who commented indicated strong opposition to allowing auditors to report in this engagement on material weaknesses not previously reported. These commenters suggested that the initial identification of a material weakness requires a level of understanding of the company's controls and the specific facts and circumstances surrounding the material weakness that can result only from a complete evaluation of the effectiveness of internal control over financial reporting. Additionally, at least one commenter expressed concern that the identification of a material weakness subsequent to the annual assessment is a strong indicator of a material change within the company's internal control over financial reporting. This commenter believed that in such a circumstance the auditor would not have sufficient knowledge of the current state of internal control over financial reporting to be able to consider the interaction and potential implications of the change on other controls. This commenter also believed that this situation would prevent the auditor, in most cases, from being able to determine whether the newly identified material weakness no longer exists.

B24. The Board decided to retain the approach described by the proposed standard. The Board believes that the issue of a newly identified material weakness being an indicator of a material change within a company's internal control over financial reporting is a valid concern. Although the change in internal control over financial reporting giving rise to any new material weakness may be confined specifically to the area in which the material weakness originally was identified, the change also could be more far-reaching. In such circumstances, the auditor may not be able to determine the effect of the change without performing a full audit of internal control over financial reporting.

B25. The Board also notes that there is an important distinction between material weaknesses previously identified in an auditor's report issued pursuant to Auditing Standard No. 2 and other newly identified material weaknesses. The primary purpose of the narrow engagement described by this standard is to establish a timely and reasonable mechanism that a company can use to remove any perceived "stain" upon its financial reporting due to an outstanding adverse audit opinion on internal control over financial reporting that identified a material weakness. In the case of a new material weakness that is identified and addressed by management as of an interim date, an adverse auditor opinion previously attesting to the material weakness would not exist and, therefore, the new material weakness would not be the subject of the same type of market focus.

B26. There is also a fundamental difference between the auditor reporting on a material weakness not previously reported and a successor auditor reporting on a material weakness that *was* reported in a predecessor auditor's opinion on internal control over financial reporting. The fundamental difference is the concept of material change described above. The successor auditor must obtain a sufficient understanding of the company's internal control over financial reporting to report on the existence of a material weakness that was previously reported. This successor auditor, however, has the benefit of knowing that the material weakness was identified in the context of an audit of the internal control over financial reporting as a whole and that the predecessor auditor should have adequately described the nature of the material weakness (particularly its pervasiveness and the extent of its effect on the company's financial reporting). In contrast, in situations in which a material change has taken place and a new material weakness has arisen after the previous annual assessment of internal control over financial reporting, neither the predecessor nor the successor auditor has obtained this level of understanding as it relates to the newly identified material weakness.

B27. These considerations, taken together, resulted in the Board's decision to retain the provisions of the proposed standard that limit this engagement only to material weaknesses that have been previously described in an auditor's report issued pursuant to Auditing Standard No. 2. The Board also made changes to the standard, as suggested by one commenter, to make these provisions clearer. These changes included changing the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" as well as conforming changes to the text of the standard to refer explicitly to a *previously reported* material weakness as the subject matter of this engagement.

Focus on Control Objectives

B28. The proposed standard focused on stated control objectives to determine whether a material weakness continues to exist and posited that if a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. Because the term "stated control objective" was not precisely defined elsewhere in the Board's auditing standards, the proposed standard provided a definition as well as examples of stated control objectives.

B29. A *stated control objective* in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. The stated control objective would provide management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist. For this reason, the proposed standard required that management and the auditor be satisfied that if the stated control objective were achieved the material weakness would no longer exist.

B30. Comments on the proposed standard's focus on control objectives came primarily from auditors. Many auditors, either explicitly or implicitly, supported the focus on control objectives. One auditor suggested that, given the importance of control objectives, the proposed standard should explicitly state that documentation of control objectives is required.

RELEASE

B31. Several auditors, however, expressed concerns about the proposed standard's focus on control objectives. A couple of these commenters suggested that the proposed standard's emphasis on control objectives might inappropriately establish a framework for evaluating the effectiveness of internal control over financial reporting that differs from, or otherwise adversely affects the proper application of, the Committee of Sponsoring Organizations of the Treadway Commission's publication *Internal Control – Integrated Framework* ("COSO").

B32. Most concerned commenters expressed apprehension that report users might be misled by an auditor's opinion that a material weakness had been eliminated because the control objectives had been met. They believed that this type of opinion might lead report users to mistakenly believe that if the control objectives were met, there were no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness—when, in fact, a significant deficiency or deficiency could continue to exist.

B33. Another commenter noted that the examples in the proposed standard illustrated only control objectives for the control activities component of internal control over financial reporting—not for the other components (control environment, risk assessment, monitoring, information and communication). This commenter suggested that examples of control objectives in the other components would be helpful. Another commenter suggested that, given the importance of the control objective concept, if the Board's standards were to specifically address the concept, such a definition and discussion should reside in Auditing Standard No. 2. One concerned auditor concluded that, given the importance of control objectives, more guidance was needed, including clarification that if more than one control is necessary to achieve a stated control objective, all such controls must be identified and tested as part of this engagement.

B34. In response to comments, the Board decided to retain the definition of, and focus on, control objectives and provide additional guidance. The Board views the auditor's use of the concept of control objectives as analogous to the use of the concept of relevant assertions. The concept of relevant assertions was already familiar to experienced auditors and was specifically defined for the first time in Auditing Standard No. 2 because of that standard's focus on testing controls over all relevant assertions related to all significant accounts. Similarly, the concept of control objectives is familiar to most experienced auditors and is already used to describe the auditor's

RELEASE

responsibilities under Auditing Standard No. 2).[6/] A definition of control objectives (and stated control objectives) is provided in this standard because of the standard's focus on control objectives as a specific measure for determining whether a material weakness continues to exist. This is consistent with the Board's objective for its standards to be clear as well as the focus on control objectives in the engagement described by this standard.

B35. The Board believes that the standard's focus on control objectives is sound and helpful and is an appropriate complement to the control criteria, such as COSO, for the purposes of this engagement. 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 to be applied to the facts and circumstances in a reasonable and appropriate manner. Accordingly, the emphasis in this standard on control objectives is consistent with, and supports a correct application of, COSO.

B36. The focus on whether the stated control objectives have been met as the target for determining whether a material weakness continues to exist does accommodate the circumstance in which a deficiency or significant deficiency continues to exist in that area of the company's internal control over financial reporting. Although several commenters linked this result with the focus on control objectives, this potential result would exist in any case within the overall construct of this standard, completely apart from the focus on control objectives. The potential for less severe deficiencies to persist in an area in which a previously reported material weakness no longer exists parallels the reporting results of an engagement performed under Auditing Standard No. 2.

[6/] For example, paragraph 12 of Auditing Standard No. 2 states, "Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." Paragraph 85 of Auditing Standard No. 2 elaborates on this idea, including the example that, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. That paragraph concludes with the statement, "When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the [deficient] preventive control relates." Perhaps most notably, paragraph 88 of Auditing Standard No. 2 requires the auditor to identify the company's control objectives in each area and identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.

RELEASE

According to that standard, only material weaknesses (not less severe weaknesses) are disclosed in an auditor's report and only the existence of a material weakness and not less severe weaknesses affects the auditor's opinion on the effectiveness of the company's internal control over financial reporting. As an illustration, assume that a company that had previously reported a material weakness in internal control over financial reporting elected to wait until the auditor's next annual report issued pursuant to Auditing Standard No. 2 to obtain auditor assurance related to the existence of the material weakness. If the control weakness that had previously risen to the level of material weakness were reduced to a significant deficiency or deficiency as of the company's next year-end, the auditor's next report issued under Auditing Standard No. 2 would present an unqualified opinion indicating that the company's internal control over financial reporting was effective. The Board concluded that the users of an auditor's report on whether a previously reported material weakness continues to exist need only receive auditor assurance that the material weakness no longer exists and not more detailed information about whether less severe control deficiencies continue to persist.

B37. The Board notes, however, that paragraph 140 of Auditing Standard No. 2 states (in part) that strong indicators of a material weakness include circumstances in which significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. An auditor is not required to provide an opinion under this voluntary engagement, and could reasonably decline to provide an opinion under such circumstances.

B38. In response to comments that report users will mistakenly believe that an auditor's report issued pursuant to the standard's provisions is communicating auditor assurance that no control deficiencies exist in the area related to the former material weakness, the Board decided that the change in the title of the standard and the form of the auditor's opinion (discussed further in paragraph B14), coupled with this discussion, would sufficiently mitigate any potential for report users to misunderstand the assurance being provided by an engagement conducted under the this standard. Removing the concept of control objectives from the standard would not address the potential for misunderstanding because this potential exists independently of the focus on control objectives.

RELEASE

B39. With regard to the recommendation that the standard provide additional examples of stated control objectives, including stated control objectives related to components of internal control over financial reporting other than control activities, the Board determined that the provisions of the standard should remain largely at the conceptual level and state that the other components of internal control over financial reporting can be expressed in terms of control objectives. The Board also determined to emphasize, in the note to paragraph 17 of the standard, that when a material weakness has a pervasive effect on the company's internal control over financial reporting, it may be difficult to identify all of the relevant control objectives and the material weakness probably is not suitable for this type of narrow, interim reporting.

B40. For the purposes of this engagement, a stated control objective need not be more precise than to describe an objective that relates to whether there is a more than remote risk that the company's financial statements are materially misstated in a given area. For instance, paragraph 14 of the standard includes the example control objective, "The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example assumes that the product X inventory account related to the company's Dallas, TX warehouse represents a more than remote risk of material misstatement to the company's financial statements taken as a whole and has been identified as a separate significant account. This example does not suggest that a company should establish separate control objectives for all of its various types of inventory, by inventory location, regardless of materiality.

B41. Although the Board believes that the proposed standard made clear that in performing this engagement, the auditor should identify and test all controls necessary to achieve the stated control objective, based on the importance of this concept and in response to commenters, the Board concluded that an explicit clarification should be added. Not only must newly implemented or modified controls be identified and tested in this engagement, but *all* controls necessary to achieve the stated control objective must be identified and tested. For example, in a circumstance in which four controls must operate effectively for a given control objective to be achieved, the failure of one of those controls could result in a material weakness. In the context of this engagement, all four controls necessary to achieve the stated control objective would need to be specifically identified and tested. This must be the case because of the inherent limitations in internal control over financial reporting. If three of the four controls were found to be effective as of year-end, they cannot be assumed to be effective as of a later date. To render an opinion as of a current date about whether the material weakness exists, the auditor must have current evidence about whether all controls (in this example, all four controls) necessary to achieve the control objective are designed and operating effectively.

B42. Regarding the suggestion to include a requirement that control objectives be documented, the Board notes that neither COSO nor Auditing Standard No. 2 currently contain such a requirement. As with many aspects of assessing the effectiveness of internal control over financial reporting, the better the documentation, the easier and more efficient the evaluation, especially from the auditor's perspective. In the context of this engagement, by virtue of creating a stated control objective, the company and the auditor would document the stated control objective, even if that documentation appeared only in their respective reports. Therefore, documentation is effectively required for the stated control objectives encompassed by an engagement conducted under this standard. The Board does not believe, however, that establishing a broad requirement for documenting *all* control objectives related to a company's internal control over financial reporting is needed at this time or would be appropriately placed within this standard.

Concept of Materiality

B43. To provide direction on the concept of materiality, the proposed standard largely referred to Auditing Standard No. 2. The proposed standard stated that 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 whether a previously reported material weakness continues to exist. 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.

B44. Several auditors commented that the proposed standard should provide additional direction on how the auditor considers materiality in performing this engagement. Commenters believed that clarification was necessary regarding the appropriate time context for management's and the auditor's materiality judgments. These commenters asked whether materiality should be assessed as of the date management asserts to be the date at which the material weakness no longer exists, or as of the end of the prior year when the material weakness was originally reported.

B45. Most commenters on this issue suggested that the date for assessing materiality should be the date management asserts to be the date at which the material weakness no longer exists. Commenters noted, however, that this position would allow a material weakness to no longer exist merely as a result of a business acquisition or disposition, for example, because either of those actions would change materiality as of that point in time (and, in the case of a disposition, send the material weakness along with the disposed business).

B46. Several auditors suggested that the auditor's opinion should explicitly recognize the concept of materiality. Commenters suggested the following as alternatives that would recognize materiality: "Management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated, in all material respects . . ." and "XYZ Company has eliminated the material weakness with respect to the Company's internal control over financial reporting as described above as of [*date specified in management's assertion*], in all material respects." These commenters were concerned that the opinion described by the proposed standard misrepresented the precision of the auditor's assessment and neglected the notion of reasonable assurance.

B47. The Board decided that the provisions in the standard regarding materiality should be clarified to specify that materiality should be assessed as of the date management asserts that the material weakness no longer exists. The as-of date of management's assertion and the auditor's opinion is fundamental to the auditor's decisions about whether he or she has obtained sufficient evidence to support an opinion and to the auditor's evaluation of that evidence to form an opinion on whether the material weakness exists as of that point in time. The Board believes that the logical and internally consistent position regarding the time context for assessing materiality is to assess materiality as of the date that management asserts the material weakness no longer exists. The Board also believes that materiality can be assessed as of a date other than a financial reporting period-end. This is consistent with the Board's decision, discussed further beginning at paragraph B15, that the standard permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B48. The Board also believes that auditors should exercise caution in circumstances in which the only aspect of a previously reported material weakness that has changed is materiality (in other words, the size of the financial statement accounts has changed due to an acquisition or other activity rather than any changes in the design or operation of controls). In many such cases, the company will have undergone significant changes, with an associated change in internal control over financial reporting overall. In this circumstance, the auditor would need to perform procedures beyond the scope of work ordinarily contemplated under this standard to have a sufficient basis for his or her new assessment of materiality and an adequate understanding of the company's

RELEASE

internal control over financial reporting overall. The Board believes that, in many cases in which the company has undergone a change of this magnitude, the auditor would need to perform a full audit of internal control over financial reporting in accordance with Auditing Standard No. 2 to have a sufficient basis for assessing materiality, understanding the company's internal control over financial reporting overall, and rendering an opinion about whether a material weakness continues to exist. Also, as discussed in paragraph B37, a previously reported material weakness may no longer exist because it has been reduced to a significant deficiency. In this circumstance, if management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness.

B49. Regarding the form of the auditor's opinion and concerns that the opinion suggested by the proposed standard implied an inappropriate degree of precision and neglected the concept of reasonable assurance, the Board concluded that the provisions of the proposed standard were sufficiently clear that the auditor's objective in this engagement was to plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist as of the date specified by management. Furthermore, the auditor's report described by the proposed standard included disclosure of this objective. The Board does not, therefore, believe that report users would mistakenly believe that the auditor's opinion, as proposed, would convey absolute assurance.

B50. In addition, the Board believes that including another reference to materiality in the auditor's opinion would not add anything of substance to the auditor's conclusion and could instead impair its readability. The determination of whether a material weakness exists is inherently linked to materiality. Stating that the material weakness no longer exists in all material respects would be redundant—the equivalent of saying that the financial statements are not materially misstated in all material respects. Accordingly, the Board has not added another reference to materiality in the auditor's opinion.

Performance of Substantive Procedures

B51. The proposed standard, consistent with its reliance on the existing provisions of Auditing Standard No. 2, focused largely on the tests of controls that the auditor must perform to obtain reasonable assurance that a material weakness no longer exists. The proposed standard additionally recognized that, in some cases, the auditor also would

RELEASE

need to perform substantive procedures on account balances to obtain sufficient evidence as to whether a material weakness no longer exists.

B52. Several auditors believed that the proposed standard was too mild in its wording that the auditor "may determine" that performing substantive procedures was necessary. Those commenters believed that, to be consistent with the integrated audit concept of Auditing Standard No. 2 and to reflect the fact that identification of many material weaknesses during the past year occurred during the performance of substantive audit procedures, such wording did not adequately convey the importance of performing substantive procedures in an engagement to report on whether a previously reported material weakness continues to exist. Some commenters recommended that the standard set forth a presumptively mandatory requirement for the auditor to perform substantive audit procedures in all cases, while others suggested that strengthening the language or providing additional guidance about when substantive procedures are necessary would be sufficient.

B53. The Board continues to believe that in some circumstances, substantive procedures will not be necessary for the auditor to obtain sufficient evidence about whether a material weakness continues to exist. Like many aspects of this standard, the auditor's judgment in this area will depend on the nature of the material weakness. An auditor can obtain sufficient evidence to support an opinion on whether some material weaknesses continue to exist without the need for substantive procedures. Other material weaknesses necessitate substantive procedures for the auditor to obtain sufficient evidence. Therefore, the Board determined that it would be inappropriate to establish a presumptively mandatory requirement that substantive procedures be performed in all cases.

B54. The Board agreed, however, that the proposed standard did not sufficiently stress the potential importance of performing substantive procedures, depending on the nature of the material weakness. Paragraph 34 of the standard has, therefore, been modified in a manner that the Board believes better articulates the potential need to perform substantive procedures. An example also has been added to this paragraph of the standard to illustrate a circumstance in which substantive procedures ordinarily would need to be performed.

Using the Work of Others

B55. Similar to PCAOB Auditing Standard No. 2, the proposed standard permitted 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 applied the framework for using the work of others described in PCAOB Auditing Standard No. 2. That 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 persons performing the work.

B56. 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. 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. In contrast, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion as to whether a material weakness no longer exists would need to be applied at the control objective level.

B57. There were few comments on the provisions for using the work of others in this proposed standard. Most commenters who commented on these provisions expressed confusion about a passage in the example of proposed paragraph 36, which stated that "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." Commenters believed that walkthroughs were required in the proposed standard in all cases and that walkthroughs must be conducted by the auditor himself or herself.

B58. One auditor suggested clarifying within the proposed standard that the auditor will be able to use the work of others only in limited circumstances. This same commenter also believed that the bank reconciliation example presented in the proposed standard to illustrate how the auditor could use the work of others in this type of engagement was too simplistic and requested additional, more realistic examples.

B59. The Board continues to believe that the framework for using the work of others that was established in Auditing Standard No. 2 is appropriate for use in this context and, therefore, the provisions for using the work of others in the standard have been retained as proposed. At the same time, the Board determined that it would be helpful to clarify, through the following discussion, that the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on whether a material weakness continues to exist would need to be applied at the control objective level. A complete understanding of this feature of the standard is important because this provision allows for additional flexibility in the auditor's work.

RELEASE

B60. The auditor's opinion in this engagement is expressed only on whether the material weakness continues to exist—not on whether the individually identified controls are effective. As a result, the evaluation as to whether the auditor has obtained the principal evidence supporting his or her opinion should be made at the control objective level—not at the lower level of the controls individually identified in management's assertion and the auditor's report.

B61. If, for example, management's and the auditor's reports identify three separate previously reported material weaknesses that no longer exist, the auditor would, in effect, be rendering three separate opinions. Those opinions would indicate that each of the three individual material weaknesses continues to exist or no longer exists as of the date of management's assertion. The standard, therefore, would require the auditor to obtain the principal evidence that the *control objectives* related to each of the three identified material weaknesses were now achieved. However, the standard would not require that the auditor obtain the principal evidence that each *control specifically identified* in management's assertion as achieving the control objectives is effective.

B62. Auditing Standard No. 4 follows the same framework for using the work of others as Auditing Standard No. 2. There may, however, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The Board believes that no additional specific restriction on the use of the work of others is appropriate or necessary in the context of this engagement. Such a restriction would diminish the flexibility that the framework otherwise provides and perhaps inhibit the auditor's exercise of the judgment necessary to implement the framework appropriately. Furthermore, the Board does not believe that auditors need such direction within the standard to make appropriate decisions about using the work of others in this context.

B63. Similarly, the Board determined that no further examples of using the work of others were needed. The Board believes that additional examples demonstrating the application of the provisions in the standard for using the work of others to reflect more realistic (i.e., complex, fact-driven) situations is better handled outside of the standard itself and by auditors—in their audit methodology, training courses, and other venues.

B64. In response to confusion about the requirement for walkthroughs, the Board clarified the standard by adding a note to paragraph 38 and deleted the reference to a walkthrough from the example on using the work of others. Walkthroughs are required only of a successor auditor when the successor auditor performs this engagement before performing an audit of internal control over financial reporting in accordance with

Auditing Standard No. 2. A continuing auditor that has opined already on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment and is engaged to conduct this narrow engagement is not required to perform any walkthroughs as part of this engagement.

Dividing Responsibility

B65. Due to the narrow scope of an engagement to report on whether a material weakness continues to exist, the provisions of the proposed standard allowed the principal auditor to use the work and reports of another auditor as a basis, in part, for his or her opinion. The proposed standard also prohibited the principal auditor from dividing responsibility for the engagement with another auditor.

B66. Very few comments were received on this provision of the proposed standard. One auditor suggested that, although dividing responsibility may not be appropriate in certain circumstances, the standard should not prohibit it. Another auditor expressed confusion about whether the principal auditor could refer to the report of the other auditor but not divide responsibility with the other auditor.

B67. The Board continues to believe that, based on the nature of the engagement described by the standard, the principal auditor should be prohibited from dividing responsibility for the engagement with another auditor. The Board's consideration of the nature of this engagement included recognition of the narrow scope of the work (i.e., whether a previously reported material weakness continues to exist), that the engagement would be voluntary, and that the assignment would be non-recurring (unlike the recurring nature of the audit of the financial statements or the audit of internal control over financial reporting). The Board notes that three appropriate alternatives exist in the circumstance in which another auditor is involved and the company wants to obtain auditor assurance that a previously reported material weakness no longer exists:

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by performing all of the testing required for this engagement himself or herself.

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by using the work and reports of another auditor as a basis, in part, for his or her opinion, and by taking responsibility for the work performed by the other auditor. In this case, the auditor may not make reference to the other auditor in his or her report on whether a previously reported material weakness continues to exist.

- The company could wait until year-end when the principal auditor would report on the effectiveness of internal control over financial reporting overall under the provisions of Auditing Standard No. 2.

B68. The Board concluded that the standard was sufficiently clear that the principal auditor could not divide responsibility with another auditor and, therefore, that the auditor also could not refer to the other auditor in his or her report. Accordingly, no change has been made to the standard in this regard.

New Material Weaknesses Identified

B69. The proposed standard was silent regarding the auditor's responsibilities if, during the performance of this engagement, he or she became aware of a new material weakness not previously reported on by an auditor.

B70. Several commenters requested that the standard address the auditor's responsibilities for new material weaknesses identified during this engagement and suggested what these responsibilities should be. One investor suggested that the standard should require the auditor to include disclosure of any new material weaknesses of which the auditor was aware in his or her report. This commenter stated that, otherwise, the auditor's report would become a way of telling investors the good news while concealing the bad news. Another commenter suggested that management should be required to include the new material weakness in management's assertion that would accompany the auditor's report and the auditor should then disclaim an opinion on the new material weakness.

B71. Both the identification of material weaknesses and the remediation of such weaknesses will be captured by management's voluntary and required reporting under the SEC's rules. Accordingly, the provisions of this standard do not facilitate management's ability to conceal from investors the emergence of a new material weakness at the company. Nevertheless, the Board agreed that when an auditor identifies a new material weakness during the performance of this engagement, the auditor should not simply remain silent. Accordingly, the Board modified the standard to require the auditor to communicate, in writing, to the audit committee any material

RELEASE

weaknesses identified during this engagement that the auditor had not previously communicated, in writing, to the audit committee.

B72. The existing provisions of Auditing Standard No. 2 contain responsibilities for the auditor if (1) information comes to the auditor's attention during this engagement that leads him or her to believe, while performing quarterly procedures required by Auditing Standard No. 2, that management's quarterly disclosures are materially misleading, or (2) the auditor becomes aware of conditions that existed at the date of his or her last report issued under Auditing Standard No. 2.

B73. Paragraphs 202-206 of Auditing Standard No. 2 establish certain requirements for the auditor related to management's quarterly and annual certifications with respect to the company's internal control over financial reporting. If matters come to the auditor's attention during this engagement that lead him or her to believe, while fulfilling these quarterly requirements, that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and the SEC's rules, these provisions of Auditing Standard No. 2 require the auditor to take action. Such actions escalate from auditor communications with management and then to the audit committee, culminating in the auditor considering his or her additional responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

B74. In addition, a continuing or predecessor auditor would have responsibilities under paragraph 197 of Auditing Standard No. 2 if the existence of a new material weakness came to the auditor's attention. This paragraph effectively extends the responsibilities in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, to reports on the effectiveness of internal control over financial reporting issued pursuant to Auditing Standard No. 2. The identification of a new material weakness in the current year would cause the auditor, in fulfilling these responsibilities, to determine whether the facts relating to the material weakness existed at the date of the auditor's report pursuant to Auditing Standard No. 2 and, if so, (1) whether those facts would have changed the auditor's report issued under Auditing Standard No. 2 if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. If the auditor determined that the new material weakness identified in the current year actually existed as of the date of his or her previous report under Auditing Standard No. 2 and that it was not adequately identified and disclosed in that report, the auditor would need to take steps such as recalling and reissuing the previous report to ensure that investors did not continue to rely on the previously issued (erroneous) report.

RELEASE

B75. Including newly identified material weaknesses in the auditor's report could potentially mislead investors into believing that the assurance provided by this type of engagement is broader than it actually is. If report users were provided with disclosure (covered by the auditor's opinion) of new material weaknesses of which the auditor was aware, report users might incorrectly believe that the auditor's report captured *all* new material weaknesses that had arisen at the company. Similarly, a requirement for the auditor to disclose any new material weaknesses could lead report users to conclude, incorrectly, that no such disclosure means that there is current auditor assurance over the whole of internal control over financial reporting at the company. The objective of this engagement is to provide auditor assurance about whether a previously reported material weakness continues to exist—nothing broader. The only way for investors to obtain a more complete report from the auditor would be for the auditor to audit internal control over financial reporting in accordance with Auditing Standard No. 2.

Specific Identification of All Previously Reported Material Weaknesses

B76. The proposed standard required the auditor to modify his or her report if the auditor provides assurance on less than all of the material weaknesses previously reported. The proposed standard did not, however, require the auditor to specifically identify all of the previously reported material weaknesses not covered.

B77. All investors who commented on this issue suggested that all material weaknesses previously reported either should be referred to or specifically included in the auditor's report. They indicated that failure to identify the additional material weaknesses might lead some users to erroneously conclude that they no longer exist. Auditors, on the other hand, agreed that complete specific identification of the previously reported material weaknesses not covered by the auditor's opinion should not be included, primarily because they believe that it may increase the risk of confusion about the scope of the engagement and what is being covered in the auditor's opinion. Several commenters who agreed that specific identification was not necessary suggested that in addition to the report modification included in the proposed standard, the auditor's report on this engagement should specifically direct the reader to the previous auditor's report (issued under Auditing Standard No. 2), by either attaching a copy of the audit report or by providing direction as to where the report could be obtained.

B78. The Board believes that including a complete specific identification of the previously reported material weaknesses not covered by this engagement would prove problematic. As noted by many commenters, it is possible that including this detail would confuse report readers regarding the scope of this narrow engagement and could imply that, unless told otherwise, a report user should assume that those other material weaknesses *do* continue to exist. In some of the material weakness descriptions included in management's and the auditor's reports on the effectiveness of the company's internal control over financial reporting as of year-end, the description of multiple material weaknesses covered several pages. That level of detail in an auditor's report specifically targeted at whether just one material weakness continues to exist could easily overwhelm the rest of the audit report, making the report prone to various kinds of misinterpretations.

B79. The Board concluded that report readers would be better served by requiring the auditor to provide information regarding where to obtain the previously issued audit report—either by attaching it or referring to where it could be publicly obtained.

Other Reporting Matters

B80. *No Requirement to Issue a Report*. The proposed standard required that the auditor, if he or she concluded that the material weakness continues to exist, communicate that conclusion in writing to the audit committee. The proposed standard, however, did not require the issuance of a report. Rather, the proposed standard recognized that the auditor must consider this knowledge in connection with the auditor's responsibilities under Auditing Standard No. 2 to determine whether management's quarterly disclosures about internal control over financial reporting are not materially misleading.

B81. Several auditors who commented recommended that the proposed standard should require the auditor to issue an adverse report in the event that the auditor concludes that the material weakness continues to exist. One suggested that issuance of an adverse report would be necessary only if the auditor believed that the company had previously publicly disclosed that the material weakness had been addressed.

B82. The Board continues to believe that requiring the issuance of an adverse report to the company would serve no useful purpose in this circumstance because the company might not make such a report public. The Board believes, therefore, that requiring the auditor to communicate, in writing, with the audit committee his or her conclusion that a material weakness that was the subject of this engagement continues to exist would serve the same purpose as requiring the issuance of an adverse report. At the same time, such a requirement would provide the auditor with additional flexibility as to the form of communication that would be most meaningful to the audit committee. Regarding the potential for management to lead investors to incorrectly believe that the material weakness no longer exists in its public disclosures, the Board believes that the federal securities laws, as well as auditor's existing responsibilities related to management's quarterly disclosures, are adequate safeguards to protect investors from misleading information.

B83. *No Distinction in Standard Between Unqualified and Adverse Opinion*. As discussed in the note to paragraph 43 of the standard, the standard no longer distinguishes between an unqualified and an adverse opinion. The auditor's opinion was revised to state that the material weakness exists or no longer exists. This revision is discussed further in the section "Form of Auditor's Opinion" and is now referred to in the standard as the auditor's opinion.

B84. *Inherent Limitations*. The inherent limitations paragraph of the auditor's report provided in the proposed standard discussed the inherent limitations of internal control over financial reporting overall, rather than the inherent limitations of the controls related to the material weakness being reported on.

B85. One commenter suggested that the inherent limitations paragraph was too broad for this engagement and needed to be modified to more accurately reflect the narrow focus of this type of engagement.

B86. The Board agreed that the inherent limitations paragraph, in this context, should be targeted to the specific controls identified in this auditor report. In addition, the Board continues to believe that the broader concept of inherent limitations in internal control over financial reporting overall is equally applicable. The inherent limitations paragraph in the auditor's report has been modified to reflect both of these conclusions.

B87. *Obtaining an Understanding of Internal Control Over Financial Reporting.* The proposed standard included a required report element stating 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." This language also was included in the example report included in the proposed standard.

B88. Several auditors expressed concern that the phrase, "the engagement includes obtaining an understanding of internal control over financial reporting," implies that, as a part of the current engagement, the auditor spent a significant amount of time understanding internal control over financial reporting overall rather than carrying forward his or her understanding from the prior annual audit. These commenters believed this implication conflicted with the direction in the body of the proposed standard that an auditor who has audited the company's internal control over financial

RELEASE

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 this engagement. One commenter acknowledged that the proposed wording may be appropriate in cases in which a successor auditor is performing this engagement without previously gaining that understanding.

B89. The Board continues to believe that an auditor who has audited the company's internal control over financial reporting as of the company's most recent annual assessment 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 whether a previously reported material weakness continues to exist. To require a continuing auditor to update and document his or her understanding of internal control over financial reporting overall (to the full measure required by Auditing Standard No. 2) would be unnecessarily burdensome and costly. The Board modified the report element for a continuing auditor to clarify that the auditor previously obtained an understanding of internal control over financial reporting overall at the company and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness.

B90. The Board continues to believe, however, that a successor auditor that has not yet audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 would need to obtain a current understanding of internal control over financial reporting in connection with this engagement. Therefore, the report element described in the proposed standard is appropriate and has been retained for a successor auditor's reporting.

B91. *Example Reports*. The proposed standard included only one example report, which illustrated reporting on one material weakness by a continuing auditor when no additional material weaknesses were reported previously. Several commenters requested modification of the standard to address circumstances that the Board believed were already addressed by the proposed standard but were not illustrated in the single example report. Some commenters also made specific requests for additional example reports.

B92. The Board determined, after considering the nature of the comments, that additional example reports, while not covering all possible situations, would provide additional clarity to the various reporting situations. The Board selected three reports to illustrate most facets of the reporting provisions of the standard. Appendix A includes those reports.

Conforming Amendments to AT sec. 101

B93. The proposed standard contained a proposed conforming amendment to AT sec. 101, *Attest Engagements*. The proposed conforming amendment would have required the proposed standard to be used, rather than AT sec. 101, for any engagements in which the subject matter is whether a material weakness continues to exist. This conforming amendment would have precluded the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement was whether a material weakness continues to exist.

B94. The Board received few comments related to the proposed conforming amendment. One auditor agreed that a conforming amendment to preclude a review-level attestation was appropriate when the subject matter was whether a material weakness continues to exist. This commenter went on to suggest, however, that there could be appropriate uses for an agreed-upon procedures engagement and that the Board should not preclude agreed-upon procedures from being performed under the Board's standards. Such reports, the commenter noted, would be restricted to the use of the specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes and, therefore, these reports would not generally be available to investors. Thus, these reports would not be a substitute for the engagements addressed in the proposed standard. Another commenter separately suggested broadly retaining the ability for the auditor to perform a review engagement when the subject matter is a previously reported material weakness.

B95. The Board continues to believe that investors and other report users in the public domain will be best served by the Board's standards permitting only positive assurance (i.e., an examination-level attestation) from the auditor when the subject matter is whether a material weakness continues to exist. The Board agrees, however, that private parties (such as audit committees) who wish to engage the auditor to perform specified procedures when the subject matter is whether a material weakness continues to exist should be allowed to negotiate such a private arrangement, as long as the results are not intended for public use. The Board, therefore, decided to modify the conforming amendment to AT sec. 101 of the Board's interim standards. As adopted, an auditor may not use AT 101 to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use.

RELEASE

Appendix 2 – Conforming Amendment

Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist

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. The conforming amendment to the Board's interim attestation standards is as follows:

– *AT sec. 101, Attest Engagements*

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

Engagements in which the practitioner is engaged to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist.*