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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.

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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