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

BRIEFING PAPER

PROPOSED AUDITING STANDARD ON REPORTING ON THE ELIMINATION OF A MATERIAL WEAKNESS

MARCH 31, 2005 PUBLIC MEETING OF THE BOARD

At its public meeting on March 31, 2005, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to propose and seek comment on an auditing standard, *Reporting on the Elimination of a Material Weakness*. This briefing paper highlights the reasons for such a standard and the more significant provisions of the proposed auditing standard.

Reasons for Standard

Section 404 of the Sarbanes-Oxley Act of 2002 ("the Act") requires public companies to annually provide the investing public with an assessment of the company's internal control over financial reporting. This assessment must be accompanied by an independent auditor's report attesting to management's assessment. As companies have begun to include these reports in their annual financial statement filings, investors are receiving more information about the company's financial operations than was available to them in the past.

In some cases, the company's management and auditor agree that the company's internal control over financial reporting is effective. In other cases, however, management's assessment of the company's internal control over financial reporting may reveal that the company has one or more material weaknesses – a serious defect in the company's internal control over financial reporting. Until investors learn that the material weakness has been eliminated, they may be uncertain about the reliability of the company's financial statements.

BRIEFING PAPER

Management may determine that communicating the elimination of a material weakness through its quarterly disclosures will be sufficient to notify investors. Some investors and companies, however, have called for a mechanism for confirmation by the company's independent auditor of management's assertions about those internal control improvements.[1/] Such confirmation is not required by the Act or other securities laws, but, in appropriate cases, could provide companies with an additional vehicle for communicating with the markets. The proposed standard, therefore, would establish requirements for an entirely elective engagement to provide auditor assurance about the elimination of a material weakness.

Significant Provisions of Standard

The proposed standard is more narrowly focused than Auditing Standard No. 2, which applies to the auditor's annual report on the effectiveness of internal control over financial reporting, but draws from many of that standard’s concepts. To perform an engagement to report on the elimination of a material weakness, the auditor must have sufficient overall knowledge of both the company and its internal control over financial reporting. The auditor’s objective in an engagement to report on the elimination of a material weakness is to express an opinion on whether a previously reported material weakness has been eliminated.

Because an engagement to report on the elimination of a material weakness would be significantly narrower in scope than an audit of internal control over financial reporting, 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 as the target for determining whether the specified controls eliminate the material weakness. This approach relies on

---

[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. Several SAG members strongly encouraged the Board to undertake a standards-setting project of this nature because they predicted that both investors and issuers would request auditor assurance on a company’s elimination of a material weakness. The webcast of the November 18, 2004 Standing Advisory Group discussion is available on the Board's Web site (www.pcaobus.org).

management and the auditor reaching agreement regarding which deficient control objective caused the material weakness.

To render an unqualified opinion, the auditor must have obtained evidence about the design and operating effectiveness of the specifically identified controls, determined that the material weakness has been eliminated, and determined that no scope limitations were placed on the auditor's work.

In keeping with the voluntary nature of this reporting, the proposed standard allows for significant flexibility in the performance of an engagement to report on the elimination of a material weakness. For example:

- 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 financial statements.

- The proposed standard would allow an auditor to report on the elimination of one or more material weaknesses as part of a single engagement.

- Consistent with the framework for using the work of others that Auditing Standard No. 2 established, the proposed standard would permit the auditor to use the work of others to alter the nature, timing, and extent of the auditor's work.

- If the auditor determines that the material weakness has not been eliminated, the proposed standard would allow the company to re-address its remediation efforts, reset the assertion date and request that the auditor begin testing again in order to opine on the elimination of the material weakness. In this situation, the auditor would, however, be required to communicate his or her conclusion that the material weakness had not yet been eliminated to the company's audit committee.

Auditor assurance that a material weakness has been eliminated as of an interim date may not always be possible. For example, 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

BRIEFING PAPER

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, this type of interim engagement, with its narrow scope, may not be suitable for auditor reporting on the elimination of certain kinds of material weaknesses.

Effective Date of the Proposed Standard

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

Public Comment

If the Board issues the proposed standard, it will seek comment on the proposed standard for a 45-day period. 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 Securities and Exchange Commission 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.

* * *

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