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Public Company Accounting Oversight Board

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Statement of William J. McDonough on PCAOB Proposed Auditing Standard on Corrections of Material Weaknesses in Internal Control over Financial Reporting

March 31, 2005 Public Meeting of the Board

Today's meeting is an important step in ensuring a smooth implementation of the Sarbanes-Oxley Act's vision of restoring confidence in financial reporting in U.S. public capital markets. I commend the great body of public companies that have so ably risen, along with their auditors, to the challenge presented by the new requirements that they annually assess the quality of internal control over financial reporting. Although companies have been required to have internal control over their accounting since the Congress enacted the Foreign Corrupt Practices Act in 1977, there is no doubt that the Sarbanes-Oxley Act's requirement for annual assessments, and auditor attestations to those assessments, took corporate responsibilities to an entirely different level.

In addition, our own Auditing Standard No. 2 has significantly changed the nature of auditing in a very short period of time. Auditors have been proceeding apace on their attestation work for some time now, which has permitted many companies to identify and resolve deficiencies in internal control even before the deadlines for publishing their assessment and attestations. For calendar-year end companies, that deadline was March 16 of this year.

So far, a number of companies have disclosed one or more material weaknesses as of their fiscal year end. I understand that many of those companies have already devoted significant attention to correcting those weaknesses, well before the next annual assessment. Our proposal for a new, voluntary, auditor's engagement to attest to managements' corrections of individual material weaknesses will offer companies an opportunity to provide the investing public added assurance that previously disclosed weaknesses have been corrected.

While I heartily support this proposal, there are three aspects of the proposal that I'd like to address specifically. First, the engagement envisioned by this proposal is entirely voluntary. There are a number of other ways that public companies can complete the communication to investors that they begin when they disclose a material weakness, including for example their quarterly disclosures and certifications as to changes in internal control under Section 302 of the Sarbanes-Oxley Act. But we have developed this proposal to answer calls from both public companies and investors for an additional tool. We have no intention of proposing it in a way that could be perceived as a *de facto* required auditing service.

Second, I would like to point out that, while the proposal is based on the framework we established in AS 2, it is significantly narrower in scope than that standard. Speaking for the standards-setting staff as well as myself, that is intentional. With the exception of certain general requirements when a new auditor is retained, the proposal does not call for any review of internal control as a whole until the next annual assessment.

Third, this proposal incorporates all of the flexibility and judgment that we built into Auditing Standard No. 2, including the provisions on using the work of others. We have noted anecdotal evidence that auditors are not always using the flexibility in that underlying standard. Instead of using judgment to tailor audit programs to the nature and size of an audit client, some auditors are applying a checklist approach to all audit clients, regardless of their complexity. Auditors should apply AS 2 in a manner that is proportional to the quality of management's monitoring of controls as well as the complexity of the company. Untailored checklists, to me, are an early sign of poor quality judgments, which can lead to poor quality auditing. As I have said before, we will use our inspections – which begin this year in May – to assess the effectiveness of registered firms' implementation of AS 2, including the quality of their judgments about planning audit programs appropriate to the nature of their clients.

Finally, I want to thank you, Doug and Laura, for your consistently excellent work. I would also like to thank Tom Ray and Gordon Seymour, who couldn't be here today but contributed valuable insights and advice throughout the development of this project. And, finally, I'd like to thank two of our newest colleagues – Sharon Virag and Jake Lesser – who have shown great skill already in their work on this proposal. As I hope is clear, I am very pleased with the recommendation before us. Thank you for all the hard work.