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STATEMENT OF KAYLA J. GILLAN

March 31, 2005

Proposed Auditing Standard: Reporting on the Elimination of a Material Weakness

Thank you, Mr. Chair, Messrs Carmichael and Ray, and Ms. Phillips.

I am very pleased to support the proposal before us today, and look forward to what I trust will be a constructive and instructive public comment period. As Chairman McDonough noted, we undertook to draft an auditing standard in this area in response to requests from public companies (who want to provide their investors with mid-year reports on correcting material weaknesses, and *at times* may want to buttress their own assessments with those of their independent auditors). We also heard from auditors, who are being asked to perform this service for their clients, but are concerned with the lack of a standard to guide their performance. Lastly, we heard from investors, who want to ensure that public reports on this issue are reliable.

Reliability is the key. If a company has had to report a material weakness in its controls over financial reporting, it is essentially telling the investing public that it is reasonably possible that – so long as the weakness exists – a material misstatement will occur in the future. The material error may occur in either an upcoming annual financial report or in subsequent un-audited quarterly numbers. As we have seen in recent months, sometimes the market has anticipated this error possibility and has already factored it into a company's stock price. In other situations, the market has received the internal control reports as providing new information, and has reacted to the increased risk of erroneous future numbers by increasing the premium demanded for holding equity, thus depressing the company's stock price. Investors will be well served when companies act to remove any uncertainty as to reliability of numbers that may have been created by a material weakness disclosure.

This being said, I am concerned. Although we have clearly proposed that auditor involvement in a company's mid-year report on elimination of a material weakness is voluntary (that is, companies have complete discretion as to whether to engage the auditor or not), I share Chairman McDonough's concern (and that of other board members as well) that it may become *de facto*

mandatory. Let me point to a few behaviors that I think could contribute to a *de facto* result:

- Companies who *always* opt to engage the auditor, in *every* instance in which the company is reporting on the elimination of a material weakness. As I mentioned earlier, we have already seen that *some* material weakness disclosures result in negative market reaction, and others do not. I hope that companies consider when it is important to their investors to include the auditor in this mid-year report, and when it is not.

- Investors who *always* demand that the auditor be engaged for this purpose, regardless of the type of material weakness in question and regardless of the impact that the initial disclosure had on the market. This same comment is also applicable to others who influence company behavior, including rating agencies and D&O carriers. Again, to ensure that the costs of this stand-alone auditor engagement are justified, I urge a case-by-case approach, understanding that in any event the *annual* internal control disclosure will include the results of a complete 404 audit.

Lastly, I'd like to once again thank our stellar staff. Mr. Carmichael and Mr. Ray, you consistently demonstrate superb leadership and model the highest level of intellectual honesty for your staff. Thanks also to Ms. Phillips, Leslye Givarz, Sharon Virag, and Jeannie Boylan from the Office of Chief Auditor; Jake Lesser from the General Counsel's Office; and Samantha Ross, our Chief of Staff, for all of your long hours under tight timeframes.