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Public Company Accounting Oversight Board

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BRIEFING PAPER

BOARD CONSIDERS ADOPTING AUDITING STANDARD ON REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST

JULY 26, 2005 PUBLIC MEETING OF THE BOARD

At its public meeting on July 26, 2005, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to adopt an auditing standard, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. This briefing paper highlights the need for such a standard and the more significant provisions of the auditing standard that the Board will consider adopting.

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 attested to, and reported on, by the company's registered public accounting firm. Investors have already begun to benefit from the increased transparency that these reports provide.

In many cases, the company's management and auditor agree that the company's internal control over financial reporting is effective. In some cases, however, management's assessment of the company's internal control over financial reporting reveals that the company has one or more material weaknesses – a serious defect in internal control over financial reporting. Until investors learn that the material weakness no longer exists, they may be uncertain about the reliability of the company's financial reporting.

Companies may update the markets about the status of previously reported material weaknesses through a variety of available mechanisms. Some investors and companies, however, have called for an additional mechanism that would provide for confirmation of internal control improvements by the company's registered public accounting firm. 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 standard, therefore, would establish and describe an entirely elective engagement to provide auditor assurance that a specified material weakness no longer exists.

Significant Provisions of Standard

The standard under consideration is designed to be more narrowly focused than Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, but draws from many of that standard's concepts. The auditor's objective in performing an engagement pursuant to the proposed standard would be to express an opinion on whether a previously reported material weakness continues to exist.

Both management and the auditor would use the company's stated control objectives as the target for determining whether the material weakness no longer exists. The auditor's testing in this engagement would be limited to the specific controls necessary to achieve those control objectives. To render an opinion stating that a material weakness no longer exists, the auditor must have obtained evidence about the design and operating effectiveness of the specifically identified controls, determined that those controls satisfy the control objectives, and determined that no scope limitations were placed on the auditor's work.

The standard allows for significant flexibility in the performance of an engagement to report on whether a previously reported material weakness continues to exist. 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 standard would allow an auditor to report on whether one or more material weaknesses continue to exist as part of a single engagement.

- Consistent with the framework for using the work of others that Auditing Standard No. 2 established, the 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 still exists, the auditor would be required to communicate his or her conclusion that the material weakness still exists to the company's audit committee. However, management also would have the ability to continue its remediation efforts, make another assertion at a later date as to whether the material weakness still exists, and re-engage the auditor to report on its assertion.

Effective Date of the Proposed Standard

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

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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.