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May 16, 2005

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

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:

KPMG LLP appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness* (Proposed Standard). We fully support the Board's efforts to improve financial reporting, corporate governance and audit quality with the objective of furthering the public interest and restoring confidence in our capital markets system. Further, we support the Board in its efforts to develop a standard that establishes requirements and provides direction applicable when an auditor is engaged to report on the "elimination" of a material weakness in internal control over financial reporting.

This letter is organized by first providing our key comments and general observations on the Proposed Standard, including responses to specific questions posed in PCAOB Release No. 2005-02. Less significant and editorial comments and suggestions are included in Appendix A to this letter.

Key Comments and Observations

Use of the Term "Eliminate" – We believe that the terminology, "elimination of a material weakness," proposed for use both in management's and the auditors' reports, will result in misunderstanding by users relative to whether or not the underlying control deficiency has, in fact, been remediated. A user might reasonably conclude that, if management asserts, and the auditor attests, that a previously identified material weakness has been eliminated, then the underlying internal control deficiency no longer exists. This potential for misunderstanding also exists in those instances where a material weakness is the result of a number of aggregated deficiencies and certain, but not all, deficiencies that led to the material weakness have been remedied. Clearly, the Proposed Standard provides for reporting that a previously identified material weakness has been eliminated without requiring that the underlying control deficiency has been remedied.

In order to provide users with a more clear understanding of the extent of control deficiency remediation undertaken by management and reported on by the auditor, we recommend that the Board consider redirecting the auditors' reporting responsibility to relevant control objectives rather than to elimination of a material weakness. Specifically, we suggest that the auditors' report be directed toward providing assurance on the stated control objectives asserted by management to remedy the previously identified material weakness(es). The following excerpt from the standard auditors' report reflects revisions that illustrate this suggestion (order of paragraphs is revised):

> Management has asserted that the control(s) identified ~~above~~ **below** eliminates the **aforementioned** material weakness in internal control over financial reporting ~~identified above~~ because the control(s) achieves the following stated control objective, which is consistent with the criteria established in [identify control criteria used for management's annual assessment of internal control over financial reporting]: [state control objective addressed]. Management also has asserted that it has tested the control(s) identified ~~above~~ **below** and concluded that the control(s) was designed and operated effectively as of [date of management's assertion]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on the ~~elimination of the material weakness~~ **effectiveness of the control(s) identified below** ~~based on our auditing procedures~~.
>
> **[Describe control(s) implemented]**
>
> We have applied auditing procedures to management's assertion, included in the accompanying [title of management's report], that ~~management has eliminated the material weakness in internal control over financial reporting identified above by implementing the following control(s):~~ **the aforementioned control(s) was effective as of [date of management's assertion]**.
>
> ~~[Describe control(s) implemented]~~
>
> Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether the ~~company has eliminated a~~

> ~~previously reported material weakness~~**<u>control(s) was designed and operated effectively as of [date of management's assertion]</u>**. Our engagement included obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as we considered necessary in the circumstances. We believe that our auditing procedures provide a reasonable basis for our opinion.
>
> In our opinion, ~~XYZ Company has eliminated the material weakness~~ **<u>the control</u>** described above **<u>was effective</u>** as of [date of management's assertion] because the stated control objective ~~is~~ **<u>was</u>** met as of [date of management's assertion].

Previously Reported Material Weaknesses Not Yet Eliminated – We support the Board's approach outlined in the paragraph 52 of the Proposed Standard requiring the auditors' report to be modified when reporting on the elimination of fewer than all of the previously reported material weaknesses. To further clarify this matter, we recommend the Proposed Standard be revised to require that management, in its report, specify that its assertion does not extend to previously reported material weaknesses that are not the subject of the auditors' engagement to report on elimination.

Reporting on the Elimination of a Material Weakness Identified and Remediated as of an Interim Date – We believe that the Board, in its final standard, should provide that an auditor may report on the elimination of a material weakness <u>only</u> when such material weakness previously has been addressed in the issuer's Section 404 reporting. Paragraph E128 of Auditing Standard No. 2 indicates that, "The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct." Implicit in this statement is the recognition that the auditors' conclusion relative to the severity of an internal control deficiency is predicated on the performance of integrated audit procedures. In reporting on elimination, the auditor references the specified material weakness in the opinion paragraph. Accordingly, we believe that only those material weaknesses reported pursuant to an integrated audit engagement should be subject to auditor reporting on elimination.

Date of Assertion – Paragraph 26 of the Proposed Standard provides management with considerable flexibility in identifying a date as of which to make an assertion relative to elimination of a previously reported material weakness. We believe that the "as of" date for reporting on the elimination of a material weakness should be included in management's report and should coincide with an interim financial reporting date (i.e., an issuer's quarter-end). As indicated below, we believe that an auditor should perform some level of substantive audit procedures as part of an engagement to report on the elimination of a material weakness. Generally, we believe that it is impractical, and often not feasible, to perform substantive audit procedures other than at a financial statement close date. Accordingly, we recommend that the Board's final standard require that management's assertion relative to elimination of a material weakness coincide with the issuer's quarterly financial reporting date.

Substantive Audit Procedures – Paragraph 31 of the Proposed Standard indicates that, when reporting on the elimination of a material weakness, the auditor *may* determine that performing substantive audit procedures is necessary, depending on the nature of the material weakness. We believe that it rarely, if ever, would be appropriate for an auditor to conclude on the effectiveness of internal control without also performing some level of substantive audit procedures. As noted previously, paragraph E128 of Auditing Standard No. 2 evidences the importance of substantive audit procedures relative to concluding on the effectiveness of internal control over financial reporting. Accordingly, we recommend that the Board's final standard set forth a presumptively mandatory requirement for the auditor to perform relevant substantive audit procedures when reporting on the elimination of a material weakness in internal control over financial reporting.

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Questions regarding information included in this letter should be directed to Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: Douglas R. Carmichael, Chief Auditor and Director of Professional Standards, Public Company Accounting Oversight Board
Thomas Ray, Deputy Chief Auditor, Public Company Accounting Oversight Board

The following editorial and other comments and suggestions are presented for your consideration:

1. Paragraph 2 of the Proposed Standard provides that an auditor may conduct an engagement to report on the elimination of a material weakness if the auditor has performed an integrated audit "within the past year." It is unclear as to what timeframe "within the past year" is intended to refer. For example, should the "as of" date for reporting on the elimination of a material weakness be within one year of the "as of" date for the most recent integrated audit, within one year of the auditors' report date related to the most recent integrated audit, or within one year of some other date such as the issuer's filing of its Form 10-K? We recommend that the Board's intent be clarified in its final standard. Reference to "within the past year" also appears in paragraph 22.

2. We recommend the following modification to the note in paragraph 6 of the Proposed Standard:

   > Obtaining and evaluating evidence about whether the specified controls are designed effectively without also obtaining evidence about whether those controls operated effectively **for a sufficient period of time** would not result in the auditor obtaining....

3. Paragraph 36 of the Proposed Standard, in illustrating how to apply the guidance on using the work of others in an engagement to report on the elimination of a material weakness, states (second paragraph of the example) "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." It is unclear to us why the walkthrough would be optional for the auditor since: a) paragraph 23b requires a walkthrough for "all major classes of transactions that are directly affected by controls specifically identified by management as eliminating the material weakness" (and we believe the controls in the example in paragraph 36 clearly fit this criterion); and b) paragraph 35 states that "the auditor should perform any walkthroughs himself or herself...." We recommend that the implication of the optional walkthrough or the option as to whether the auditor may use the work of others in the walkthrough be eliminated in the Board's final standard.

4. Paragraph 40 of the Proposed Standard indicates that, in an engagement to report on the elimination of a material weakness, the auditor should obtain a written representation from management "describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting." It is unclear to us as to the timeframe that this representation is intended to address. We recommend that the Board clarify the intent of this representation in its final standard.

5. The note to paragraph 47b of the Proposed Standard indicates that the "… report element should be modified in cases in which a successor auditor's performance of this engagement is his or her *initial* engagement [emphasis added]." To reflect what we believe is the Board's intent and to avoid potential confusion regarding the aforementioned reporting element when the successor auditor has not performed an integrated audit, but has performed another engagement (e.g., a review of interim financial information), we recommend that the subject sentence be revised as follows:

> This report element should be modified in cases in which a successor auditor **did not perform the integrated audit that led to reporting of the material weakness** ~~auditor's performance of this engagement is his or her initial engagement~~.

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