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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

Re: PCAOB Rulemaking Docket Matter No. 018
Proposed Auditing Standard on Reporting on the Elimination of a Material Weakness

Deloitte & Touche LLP ("Deloitte") is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB") on its Proposed Auditing Standard on Reporting on the Elimination of a Material Weakness, PCAOB Rulemaking Docket Matter No. 018 (the "release," or the "proposed standard") (March 31, 2005). This letter is submitted on behalf of Deloitte & Touche LLP, the non-U.S. Member Firms of Deloitte Touche Tohmatsu, and Deloitte Touche Tohmatsu.

We are strongly supportive of the following elements of the proposed standard, which we believe contribute to its effectiveness:

- Very specific conditions for engagement acceptance, including that management must support its assertion with sufficient evidence (documentation) and present a written report that will accompany the auditor's report *(paragraph 7).*

- The requirement that only the current or successor auditor are permitted to perform this engagement, and that the successor auditor must obtain sufficient knowledge of the company's business and its internal control over financial reporting to address the objective of the engagement *(paragraphs 2, 23, 24).*

- The requirement that the auditor must directly obtain the principal evidence for the opinion on each material weakness and stated control objective identified in management's assertion *(paragraphs 34 and 35).*

We do, however, have comments on the proposed standard which we believe will improve its application. Our letter is organized into the following sections:

I. Overall Comments
II. Responses to Questions Posed by the PCAOB
III. Comments on Specific Paragraphs
IV. Editorial Comments

I. OVERALL COMMENTS

Title of the Proposed Standard / Reporting–-Achieving the Control Objective

As currently titled and written, the proposed standard provides guidance on reporting on the *elimination* of a *material weakness,* in an attempt to provide the public with reliable information on significant improvements in internal control. However, technically, the proposed standard would allow a company to "downgrade" a material weakness to the level of a significant deficiency, but be able to report that the material weakness had been "eliminated." We are concerned that use of terminology such as "elimination" or "eliminated" would not be in the best interest of the public, as the resulting report may mislead users into believing that there are no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness, even though one or more significant deficiencies may still exist.

We strongly believe that a more appropriate structure for the proposed standard would be for the company to report that the *control objective(s)* related to the material weakness *has been achieved,* and for the auditor to provide assurance on that assertion.

In our other comments to the illustrative report example, we have provided specific suggestions on how to revise the report to reflect this recommendation.

Proposed Standard's Relationship with Auditor's Responsibility Regarding Quarterly Disclosures

We are concerned that the current language in the release to the proposed standard may create confusion about the auditor's responsibilities with respect to management's quarterly disclosures of material changes in internal control, particularly when such disclosures include remediation of a material weakness. The proposed standard was not intended to include guidance as to procedures the auditor generally performs during the quarterly reviews; accordingly, to avoid any potential confusion, we recommend that the PCAOB compare and contrast (1) the limited procedures to be performed during a quarterly review with respect to management's quarterly disclosures of material changes in internal control (as described in PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" ("PCAOB AS 2")) with (2) procedures to be performed on management's assertion during an engagement described by the proposed standard.

We recommend that the proposed standard or release language specifically state that, with respect to quarterly disclosures about material changes in internal control, the auditor does not have a responsibility to "audit" such disclosures that management includes in its quarterly filings, but only has a responsibility to perform the limited procedures described in PCAOB AS 2 and report if the auditor is aware that the disclosures require material modification in order to be accurate and to comply with the requirements of Section 302 of the Sarbanes Oxley Act of 2002.

Guidance from the SEC

We believe that registrants will need guidance as to the form of management's assertion and the mechanism for inclusion of management's assertion and the related auditor's report in the Form 10-Q or Form 8-K. For example, it would not be appropriate for management to assert in its report that "internal control is effective" because a material weakness has been remediated. In order to make such a statement, it would be necessary for management to test and evaluate the entire internal control over financial reporting, not simply the controls related to the area with the material weakness.

Although we are aware that this concern is not relevant to the PCAOB's standard setting process because such guidance does not belong in an auditing standard, we nevertheless have concerns that lack of specific guidance in this area will lead to confusion, frustration, and diversity in practice. We plan on including a recommendation for additional guidance for registrants in our comment letter to the Securities and Exchange Commission ("SEC") during the SEC comment period for the proposed standard.

II. RESPONSES TO QUESTIONS POSED BY THE PCAOB

Question 1:

- Does the sample auditor's report included in the proposed standard clearly describe the results of the engagement?

- If not, how might it communicate more clearly to report users?

The sample auditor's report included in the proposed standard does not clearly describe the results of the engagement for the reasons cited below. To begin with, the form of report is inconsistent with other interim standards with respect to (1) the description of the report on the audit of the annual assessment (e.g., see AU 552 and AU 623), (2) references to design and operating effectiveness (e.g., see AU 324), and (3) the basis for the opinion (i.e., that "the control objective is met").

Proposed revisions to make such description consistent (see marked revisions to the introductory paragraph in the report below) further highlight the lack of clarity around the engagement in the proposed standard, particularly for a situation in which the auditor is engaged to audit the remediation of only some of the material weaknesses identified. We believe that readers may inadvertently infer that the report has addressed all material weaknesses previously reported as of the company's year end, or identified during an interim period.

In addition, we do not believe that the form of opinion is appropriate. Rather, we believe that the auditor should be reporting (1) more consistently with AU 324 and (2) similarly to PCAOB AS 2, in which the auditor expresses an opinion on management's assertion, as illustrated below.

Paragraph 47g states that the report must include an identification of the specific controls that management asserts remediate the material weakness. The illustration of the report, however, infers that only the newly-implemented controls would be described. We believe that, in many circumstances, it would be more appropriate for both management and the auditor to acknowledge that the newly-implemented controls, together with other existing controls, achieve the control objective. Accordingly, we recommend that, as part of this type of engagement, the auditor test those controls which are directly relevant to achieving the specific control objective (not simply the newly-implemented or revised controls), and that all of these controls be listed in the auditor's report.

The standard inherent limitations paragraph does not seem appropriate without specific tailoring for the subject matter of this report, which covers only one or a limited number of control objectives rather than the broader subject of internal control over financial reporting. Accordingly, such paragraph should be revised for the specific subject matter of this report.

Our recommendations for specific revisions to the illustrative report are as follows (throughout this letter, additions are shown in bold underline and deletions in double strike-through):

Report of Independent Registered Public Accounting Firm

> We have previously audited**, in accordance with standards of the Public Company Accounting Oversight Board (United States),** ~~and reported on~~ management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*~~.~~"], **and have issued** ~~. O~~**o**ur report, dated [*date of report*], **which report expressed an adverse opinion because of the existence of a material weakness(es).** ~~identified t~~**T**he following material weakness**(es)** in the Company's internal control over financial reporting **was (one of the material weaknesses) identified in our report**:
>
> [*Describe material weakness(es)*]

The existence of the material weakness(es) noted above resulted in XYZ Company failing to achieve the following control objective(s) at December 31, 200X:

[*Describe the related control objective(s) that has not been achieved because of the existence of the material weakness(es)*]

We have applied auditing procedures to management's assertion, included in the accompanying [*title of management's report*], that **they have tested the control(s) identified below and concluded that the control(s) was suitably designed and operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objective(s) identified above, related to the material weakness(es) in internal control over financial reporting identified above, was achieved at [*date of management's assertion*]**~~management has eliminated the material weakness in internal control over financial reporting identified above by implementing the following control(s)~~**. Management has asserted that the relevant control(s) in place and operating at [*date of management's assertion*] is as follows**:

[*Describe control(s)* ~~*implemented*~~]

~~Management has asserted that the control(s) identified above eliminates the 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 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 **management's assertion and on the achievement of the control objective(s) identified above** ~~the elimination of the material weakness~~ based on our auditing procedures.

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 **C**~~c~~ompany has **achieved the control objective(s)** ~~eliminated a previously reported material weakness~~ **related to a previously reported material weakness(es)**. Our engagement included obtaining an understanding of internal control ~~over financial reporting~~**relating to the above control objective(s)**, 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, **management's assertion that the control objective(s)** ~~XYZ Company has eliminated the material weakness~~ described above **was achieved** as of [*date of management's assertion*] **is fairly stated in all material respects**~~because the stated control objective is met as of [date of management's assertion]~~. **Further, in our opinion, the control(s) described above was operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objective(s) described above was achieved at [*date of management's assertion*].**

We were not engaged to and did not conduct an audit of **XYZ Company's** internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of **the Company's** internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any **other** controls of the **C**~~c~~ompany as of any date **or for any period** ~~after December 31, 200X~~, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively ~~after December 31, 200X~~ **as of [*date of management's assertion*]**.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of **the** effectiveness **of specific controls** to future periods **or to the effectiveness of internal control over financial reporting** are subject to the risk that **the** controls may become inadequate because of changes in conditions, that the degree of compliance with the policies or procedures may deteriorate, or that a material weakness in other areas has occurred.

[*Signature*]
[*City and State or Country*]
[*Date*]

Question 2:

- If the auditor does not express an opinion on all of the material weaknesses that were identified during the company's most recent audit of internal control over financial reporting, should the proposed standard require the auditor's report to specifically identify the additional material weaknesses?

- Would such a requirement provide helpful information to users or would it detract from an otherwise clear communication by implying that the auditor believes that those material weaknesses do still exist or that only those material weaknesses exist (i.e., no other controls have materially deteriorated since the date of the annual assessment of internal control over financial reporting)?

- Might specific identification of other material weaknesses not addressed by the auditor's report deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses had been eliminated?

As discussed above, in order to prevent users from mistakenly believing that management's assertion and the related auditor's report address all material weaknesses, we believe that it is necessary to identify that there are other material weaknesses not addressed in either management's assertion or the related auditors' report. The language that we propose above would not make it necessary to specifically cite what the other material weaknesses were; however, a paragraph such as the following could be added for further clarity:

> Management's assertion does not address the other material weaknesses that were reported as of December 31, 200X relating to [*describe nature of such material weaknesses*]; nor were we engaged to apply auditing procedures to such areas as of or for any date or period subsequent to December 31, 200X. Accordingly, we express no opinion, or any other form of assurance, on whether such material weaknesses are still in existence or whether the control objectives related to the material weaknesses have been achieved.

Whether such language deters companies from engaging the auditor to perform work on the remediation of some but not all material weaknesses will depend on a variety of factors. If an excluded material weakness related to a control objective that is only relevant to year-end financial reporting, such language should not be a deterrent. If the excluded material weakness relates to a more significant area than the one that the company has asserted has been remediated, it might rightfully serve as a deterrent. If a third party is driving the request, the third party may not be interested in any material weaknesses other than in a specific area that affects their relationship with the company, and such language should not, therefore, be a deterrent, assuming that management's assertion and the auditor's report addresses the material weakness in which the third party is interested.

Question 3:

- Should this standard allow an auditor to report on the elimination of a material weakness in the circumstance in which the material weakness was identified and eliminated by management as of an interim date?

We do not object to allowing reporting on a material weakness identified and remediated as of an interim date. However, if the proposed standard was to allow this, it should provide specific guidance as to the appropriate form of reporting. For example, the reference to the report issued relating to the prior annual evaluation would not be relevant if such report expressed an opinion that internal control was effective at such date. Additionally, the report would need to reference whatever statements management previously made when reporting the material weakness to the public (e.g., the disclosures in the company's Form 10-Q). Also, if the auditor is reporting on fewer than all of the material weaknesses previously reported as of the company's year end, or identified during an interim period, the report should specifically state that the material weaknesses being reported on is one of others identified, so that the reader is alerted to the fact that other material weaknesses may continue to exist.

III. COMMENTS ON SPECIFIC PARAGRAPHS

We have the following other substantial comments on the proposed standard:

Paragraph 5--Selection by management of any date for their assertion
Many of the material weaknesses identified during the most recent annual reporting period related to the control environment or controls relating to the financial closing process. Accordingly, we recommend that these engagements only be performed as of quarterly dates for U.S. issuers, instead of at any date during the year. This requirement would also provide the auditor with the added benefit of being able to consider the results of interim review procedures (AU 722) when rendering a report under this proposed standard, as well as provide a link between the auditor's report and management's quarterly disclosure of material changes in internal control. However, as foreign filers do not report quarterly, special guidance would be needed as to how this guidance would be applied to foreign filers. For example, the PCAOB may consider stating that these engagements can be performed for foreign filers as of a date that corresponds with issuing press releases on interim financial information that are filed with the SEC.

Paragraph 24–-Not able to obtain a sufficient basis
This paragraph states that in certain circumstances (based on the nature of the company and the pervasiveness of the specific material weakness), the successor auditor may determine that he or she is not able to obtain a sufficient basis for performing this type of engagement without performing a complete audit of internal control over financial reporting. We strongly support this concept, however, we believe that this statement also holds true for the current auditor. Accordingly, we recommend that a similar statement be explicitly included in the proposed standard, related to the *current* auditor.

Paragraph 26–-Operating effectiveness
The note to paragraph 6 states that if the auditor does not test the operating effectiveness of a specified control, then the auditor would not be able to obtain reasonable assurance for the purpose of expressing an opinion on this type of engagement. As management and auditors may not be able to test the operating effectiveness of newly-designed, infrequent, non-recurring controls until the applicable event or transaction recurs (e.g., controls relating to the appropriate accounting for an acquisition), we recommend that the proposed standard

specifically state in paragraph 26 that there may be certain material weaknesses for which this type of engagement cannot be performed, unless the applicable controls operated before or as of the date stated in management's assertion.

Paragraph 31--Guidance on performing substantive procedures
This paragraph simply states that the auditor *may determine* that performing substantive procedures to support recorded financial statement amounts affected by the identified controls is necessary to obtain sufficient evidence regarding the operating effectiveness of controls. Given that many material weaknesses are identified through the detection of material misstatements as a result of substantive procedures, we strongly recommend that additional guidance be included in the proposed standard to clarify how and when substantive procedures would be performed during this type of engagement. It would be very helpful to provide examples of situations where it would be necessary to perform substantive procedures in conjunction with testing of design and operating effectiveness of the applicable controls (e.g., deficiencies in control activities relating to the processing of transactions).

Paragraph 35--Using the work of others
As the scope of this type of engagement will be very narrow in focus, using the work of others will occur in only limited circumstances. We recommend expanding such thoughts in paragraph 35, as follows:

> 35. …Because the scope of an engagement to report on the elimination of a material weakness is more narrowly focused that an audit of the effectiveness of internal control over financial reporting overall, each of the controls identified in an engagement to report on the elimination of a material weakness is significant to the engagement. **Accordingly, the auditor will be able to use the work of others in only limited circumstances.** Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

Paragraphs 33, 35 and 36–-Requirement to perform walkthroughs when using the work of others
Paragraph 33, in the requirement that "the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2," omits the reference to paragraph 116, which relates to the requirement for the auditor to perform walkthroughs. Paragraph 35 then includes a requirement for the auditor to perform walkthroughs himself or herself, which raises the question as to whether the requirement in paragraph 35 differs from the requirement in paragraph 116, and if so, how? We recommend that paragraph 33 include a reference to paragraph 116 and that the last sentence of paragraph 35 be deleted.

Paragraph 36 then provides an illustration of how to apply this section. The second paragraph of the illustration states that "The auditor ***might*** perform a walkthrough of the reconciliation process himself or herself" [emphasis added]. This sounds inconsistent with the requirement to perform a walkthrough him/herself. To clarify the example and to avoid potential confusion that walkthroughs are not required when using the work of others, we recommend the following revisions to paragraph 36:

> 36. …If these conditions describe the specified controls over the preparation of bank reconciliations, the auditor could determine that, based on the nature of the controls as described above, he or she could use the work of others to a moderate extent, provided that the degree of competence and objectivity of the individuals performing the tests is high. **For example,** ~~T~~**t**he auditor ~~might~~ perform**s** a walkthrough of the reconciliation process himself or herself; perform**s** testing at a limited number of locations himself or herself; test**s** the work of others performed at a limited number of other locations; review**s** the results of the work of others at all other locations tested; and determine**s** that, qualitatively and quantitatively, principal evidence had been obtained. …

We also recommend using a different, more helpful example in paragraph 36 to illustrate how the auditor may use the work of others in this type of engagement. We believe that the bank reconciliation example is too simplistic and not realistic, especially given the nature of the material weaknesses disclosed to date. We recommend that the PCAOB consider including an example related to controls over accounting for leases, taxes, or other areas where registrants have disclosed the existence of material weaknesses.

Paragraph 37–-Dividing responsibility
While dividing responsibility may not be workable in certain situations, we believe that the proposed standard should not prohibit it. For example, a material weakness might relate to activities that are performed at numerous subsidiaries. If the auditor of a significant subsidiary applied auditing procedures to management's assertion regarding the remediation of the material weakness at one subsidiary and issued a report thereon, it would seem reasonable that the principal auditor might divide responsibility with respect to the portion of the material weakness remediated at that particular subsidiary. We would agree that responsibility could not be divided if the auditor of the subsidiary did not issue such a report.

Paragraphs 39, 41 and 51--Scope limitations
The proposed standard contains very circular cross-references within paragraphs 39, 41 and 51 regarding the effect of scope limitations on the engagement. We recommend that paragraph 39 contain all the guidance regarding the auditor's actions when faced with a scope limitation and that paragraphs 41 and 51 refer back to paragraph 39. Accordingly, we recommend (1) deleting the reference in paragraph 39 to paragraph 51, (2) replacing the reference to paragraph 51 in paragraph 41 with a reference to paragraph 39, and (3) deleting the last sentence of paragraph 51.

Paragraph 47–-Reference to the predecessor auditor's report
We believe that the phrase in the note to paragraph 47b, "or, if necessary, to the predecessor auditor's report," is unclear. It would certainly be necessary to reference a predecessor auditor's report, including identification of the material weaknesses, when there are more than one material weakness and the successor auditor is engaged to apply auditing procedures to

fewer than all previously reported materially weaknesses. But in what situations would it *not* be "necessary"? It might be inappropriate to reference the predecessor auditor's report if the material weakness arose subsequent to such report or if the successor auditor believed that such report was erroneous. However, in the latter case, the successor auditor would probably conclude that he or she should not accept the engagement to apply audit procedures or that he or she should resign from the engagement. Accordingly, we recommend that, in successor auditor situations, the auditor's report on the remediation of a material weakness should explicitly refer to the predecessor auditor's report unless the material weakness arose in an interim period. As discussed above, specific reporting guidance is necessary if the auditor is permitted to apply auditing procedures to a material weakness that arose in an interim period.

Paragraph 49–-Modifications to the report when reporting on more than one material weakness
Paragraph 49 states that the report elements in paragraph 47 should be modified if the auditor reports on the remediation of more than one material weakness but provides no guidance with respect to specific modifications. We recommend that specific guidance be provided or that the paragraph be deleted.

Paragraph 53–-Adverse reports
While we agree with and strongly support the requirement for the auditor to communicate in writing to the audit committee if he or she does not believe the material weakness has been eliminated, we believe that the proposed standard should require the issuance of an adverse report. This adverse report does not need to be made available to the public, but it is appropriate for the auditor to formally document and report his or her conclusions when a conclusion has, in fact, been reached.

IV. EDITORIAL COMMENTS

In addition to the more substantial comments noted above, we also have editorial comments, as described below.

Paragraph 22
Rather than carving out a procedure in paragraph 23 that would not be performed, we recommend that the note to paragraph 22 refer only to the specific steps that would be performed, as follows:

> 22. …the auditor should follow the requirements for a successor auditor in paragraphs 23**a-b** and 24~~, except paragraph 23c~~.

Paragraph 25
In the first sentence of paragraph 25, we recommend that further clarification be made to the phrase "are designed and operated effectively," such as the following:

> 25. The auditor must obtain an understanding of and evaluate management's evidence supporting its assertion that the specified controls related to the material weakness are **suitably** designed and operated effectively **for a suitable period of time**, that these controls achieve the company's stated control objective(s)…

Paragraph 45
We believe that paragraph 45d should refer to "management's assertion" (singular) not "management's assertions."

Appendix 2
We believe that the reference to "AICPA *Professional Standards*, vol. 1" in footnote 15 should be to the PCAOB Interim Standards.

We appreciate the opportunity to comment, and would be pleased to discuss these matters with you further. If you have any questions or would like to discuss these matters further, please contact Robert J. Kueppers at (203) 761-3579 or John A. Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB
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