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Mr. J. Gordon Seymour
Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

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

Dear Mr. Seymour:

We are pleased to comment on the PCAOB's proposed auditing standard (the "Proposed Standard") related to the reporting on the elimination of a previously disclosed material weakness in internal control over financial reporting.

The Proposed Standard would provide a mechanism for issuers that have identified and reported one or more material weaknesses in their internal control over financial reporting to inform investors and others, with the added assurance, where possible, of the company's independent auditor, that the material weaknesses have been eliminated. We recognize that issuers, investors and other capital market participants may desire and benefit from timely, positive assurance from independent auditors on the elimination of such material weaknesses rather than having to wait until the following year's 404 reports for such assurance.

As a general matter, we have concerns regarding an auditor's issuance of interim reports on narrow aspects of a company's overall internal control over financial reporting. Because internal control is dynamic and changes over time, there is the possibility that, at the same time that a previously identified material weakness is eliminated, other controls might no longer be operating effectively. We have significant reservations regarding the possibility of misinterpretations and the potential for expanding (rather than narrowing) the "expectation gap" if auditors provide reports with positive assurance at interim dates when an integrated audit has not been performed. Accordingly, we would prefer not to issue these reports. In addition, if such reports are to be issued, we would prefer an alternative model whereby we would provide negative assurance on the elimination of a material weakness in a manner similar to the negative assurance provided on issuers' quarterly financial information filed with the SEC.

Notwithstanding these reservations, considering our profession's unique role in the capital markets and our ability to provide a beneficial service to issuers, investors, and others, we understand the need for the Proposed Standard and, with certain recommended changes, support its issuance. Our concerns regarding the proposed reporting model can be mitigated through appropriate communication and disclosures by issuers and auditors, provided there is clear recognition by all capital market participants of the targeted scope of such reports.

We believe the guidance in the Proposed Standard generally serves the needs of issuers, investors, and auditors by establishing appropriate engagement acceptance, performance and reporting guidance, and we commend the Board for its timely development of the proposal. However, we believe the guidance could be improved in certain respects as described below. We have organized our comment letter to respond to the three specific issues on which the Board seeks public comment as identified in the Release in Item IX, *Opportunity for Public Comment*, and then to provide additional comments that do not relate to these particular issues.

Specific Issues on which the Board Seeks Comment

1. Does the sample auditor's report, which is included in the proposed standard, clearly describe the results of the engagement? If not, how might it communicate more clearly to report users?

   We are in general agreement with the example auditor's report. We believe the overall approach of requiring management to issue an acceptable assertion as a condition for engagement performance, requiring the auditor to state in the report that the auditor examined management's assertion, and require an opinion on the subject matter (but not management's assertion) will clearly communicate to users. We recognize that this differs from the reporting model in Auditing Standard 2 in which the auditor's annual report includes an opinion on management's assessment, but the elective nature of this engagement and the requirement for an acceptable assertion supports the form of report proposed.

   However, we believe the auditor's report elements should specifically require the auditor to state that the auditor examined (or audited) management's assertion. Paragraph 47d requires the auditor to identify management's assertion that it has eliminated the identified material weakness in internal control over financial reporting, and the illustrative report states that the auditor "applied auditing procedures" to management's assertion. For consistency, we believe the illustrative report also should be revised to state that the auditor examined (or audited) management's assertion (rather than stating that the auditor applied auditing procedures.)

Additionally, we believe the standard should require management to specify a date as of which the material weakness has been eliminated, rather than requiring the auditor to opine that the material weakness has been eliminated as of the date "of" management's assertion. We believe this approach is supported by the fact that there currently is no requirement for management to date the management report containing the assessment of internal control over financial reporting (and many management reports issued and filed have not been dated), but under Auditing Standard 2 there is a clear requirement for management to indicate an "as of" reporting date—the measurement date as of which management made its assessment. Similarly, we believe management should be required to assert that the material weakness has been eliminated as of a specific reporting date, and the auditor should similarly opine on the elimination of the material weakness as of this date. Finally, there should be clarifying language that would indicate this need not be the first date as of which the material weakness was eliminated, but only a measurement date for purposes of the assertion and audit.

We also note that the proposed opinion states: *"In our opinion, XYZ Company has eliminated the material weakness described above as of [date of management's assertion] because the stated control objective is met as of [date of management's assertion]."* We believe it is unnecessary and inappropriate to include the phrase "because the stated control objective is met as of…" because (1) the report otherwise describes the controls implemented and the related control objectives, and (2) there are other factors the auditor considers in reaching the opinion. Accordingly, we suggest deleting this phrase from the opinion.

We also have a concern regarding the lack of a reference in the opinion to materiality. The material weakness being eliminated previously was identified as part of an integrated audit of the financial statements and internal control over financial reporting, and the determination that the control deficiency constituted a material weakness included consideration of materiality as required by Auditing Standard 2. We believe that a conclusion as to the elimination of a material weakness also requires consideration of materiality, and that the auditor's opinion should inform the reader that it is being given with respect to internal control over financial reporting. The Proposed Standard should be revised to address how the auditor considers materiality in performing this engagement, and should specifically state that materiality is considered as of the date of management's assertion that the control has been eliminated.

Accordingly, in summary, we believe the example opinion should be revised in the following manner: "In our opinion, XYZ Company has eliminated the material weakness with respect to the company's internal control over financial reporting as described above as of [date specified in management's assertion], in all material respects." We also recommend corresponding changes to the reporting elements in paragraph 47.

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 report 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?

   If more than one material weakness was identified in the previously issued auditor's report and management has eliminated some but not all of those material weaknesses, we believe management should disclose in its assertion, and the auditor should disclose in the auditor's report, that the previously issued reports described additional material weaknesses that were not included in the scope of the engagement, and accordingly, the auditor is not opining on whether any material weaknesses other than those specifically described in the report have or have not been eliminated. Additionally, management and the auditor should refer the reader to the previously issued annual report for additional information on those material weaknesses.

   We believe that the Proposed Standard appropriately emphasizes clear communication to users of the report of the scope of the engagement, including a clear communication that the auditor is not opining on the elimination of all material weaknesses if some material weaknesses have not yet been eliminated or if the auditor is unable to obtain sufficient evidence to conclude that they have been eliminated. We agree with this emphasis, even if this reporting requirement deters some companies from engaging the auditor to perform this work in such situations. The Proposed Standard appropriately permits reporting by the auditor on the elimination of some but not all material weaknesses if companies so choose to engage their auditors, and appropriately requires in such situations clear communication of the existence of previously reported material weaknesses not covered by the auditor's report – the clarity of such communications is important to investors and other users of the reports.

We do not believe the report need identify each material weakness that was not covered, but it should identify the fact that not all previously reported material weaknesses are included in the scope of the examination. Management could provide additional disclosures to the reader in management's assertion regarding the material weaknesses that were not included in the scope of management's assertion and the auditor's report.

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 (in other words, identified and eliminated without ever being addressed in the company's Section 404 reporting)?

   No. We do not believe the Board should provide for reporting on the elimination of a material weakness that was identified by the Company at an interim date and also eliminated as of an interim date. First, we do not believe there will be significant demand or need for such a service. The driving force behind the Proposed Standard is the *annual* issuance of the Section 404 report on internal control over financial reporting with no reporting mechanism for communicating until a year later when the next Section 404 report is issued. In the case of an interim identification of a material weakness, that time period is, by definition, much shorter.

   Additionally, in such cases, the material weakness would most likely have arisen as a result of a material change that occurred since the Company's prior annual report. Until the next full management assessment and integrated audit is performed, we do not believe the auditor will have considered the interaction and potential implications of the change resulting in the material weakness and the change eliminating the material weakness to other controls and processes. Accordingly, until the next integrated audit is performed, we do not believe the auditor, in most cases, would have the knowledge of the current state of internal control to be able to evaluate the changes that have occurred and whether the newly identified material weakness has truly been eliminated.

   Finally, we believe a report on the elimination of a material weakness that was never identified as a material weakness in the prior Section 404 report could be very confusing to investors. At a minimum, such a report would need to include disclosure not only of the material weakness, but also of the changes that occurred subsequent to the previously issued 404 report that created the material weakness and the changes that eliminated the material weakness.

Other Comments

1. We note in Section VIII, *Conforming Amendments*, of the Release that if the Board adopts, and the SEC approves, the Proposed Standard, the Board's interim standards would be amended to preclude the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement is the elimination of a material weakness. If the Proposed Standard as finalized retains the provision of positive assurance, we would agree that a conforming amendment would be appropriate to preclude a *review level attestation* engagement when the subject matter is the elimination of a material weakness. However, there could be appropriate uses for an *agreed-upon procedures* engagement in which the subject matter is the elimination of a material weakness and in which the report is restricted to specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes, and accordingly, we do not believe the Board should preclude such engagements from being performed. As a practical matter, we also point out that because such reports would be restricted to the specified parties, they would not be made generally available to investors, and thus such engagements would not be a substitute for the engagements addressed in the Proposed Standard. However, there might be situations where engaging the independent auditor to perform agreed-upon procedures for the restricted use of specified parties would be useful.

2. We note Sections II-VI of the Release contain information that is helpful in understanding the meaning and implications of requirements in the Proposed Standard. We believe the final standard should include this material (e.g., in an appendix or other section describing the Board's basis for conclusions) to facilitate understanding and consistent application of the final standard.

3. We believe the issuance of the Proposed Standard will result in questions regarding (a) the procedures management should perform to provide a basis for management's Section 302 disclosures in situations where a material weakness has been reported in the previous annual auditor report on internal control over financial reporting, and (b) the procedures the auditor should perform when management makes such a disclosure. For example, management may identify a material weakness at its assessment date, and subsequently remediate that material weakness and communicate the material changes that were part of the remediation in its quarterly 302 disclosures. The Proposed Standard would establish a requirement, with respect to a management assertion for this engagement, for management to evaluate the effectiveness of the controls that eliminate the material weakness and to support its assertion that the material weakness has been eliminated with sufficient evidence. This raises the question regarding whether management has the same responsibility to evaluate the controls with sufficient evidence if it states in its quarterly disclosures and certifications that its disclosure controls and procedures that

were previously ineffective because of a material weakness are now effective. It also raises the question regarding whether the auditor has a responsibility to determine if management has evidence to support such a disclosure as part of the auditor's SAS 100 procedures. We believe the Board (and the SEC) should clarify that the guidance pertaining to an engagement performed in accordance with the Proposed Standard does not otherwise extend to either management's disclosures or the auditor's SAS 100 procedures.

4. We recognize and agree with the focus on control objectives (or "what could go wrong" questions) in the Proposed Standard, and the importance of determining whether controls are suitably designed and operating effectively to achieve those objectives. We believe COSO and Auditing Standard 2 include the concepts of control objectives, but do not explicitly require documentation of control objectives. We believe the Board should consider explicitly stating that documentation of control objectives is required.

5. Auditing Standard 2 (paragraphs B18-B29) and PCAOB Staff Question and Answer 24-26 and 28 address situations in which a company uses a service organization. The inability to obtain a SAS 70 report or other evidence of the effective operation of controls at a service organization may result in a material weakness and adverse opinion on internal control over financial reporting. We believe a Company that has such a material weakness may conclude that the subsequent receipt of a SAS 70 report would eliminate such a material weakness. However, we can foresee a number of questions and issues regarding whether such a report is sufficient for the Company to assert and the auditor to opine that the material weakness has been eliminated, including whether the time period covered by the tests of controls described in the SAS 70 report needs to include the current as-of date that the material weakness has been eliminated or the prior assessment date, or both, or neither (e.g., the report covers a portion of the prior year but does not include the Company's assessment date.) We believe the Proposed Standard should be revised to address how the auditor should consider the time period covered by a SAS 70 report in determining whether such a report provides evidence that a material weakness has been eliminated. The Proposed Standard also should be revised to address other factors that management and the auditor should consider in determining whether a SAS 70 report truly eliminates the material weakness, including the effect of any user control considerations identified in the SAS 70 report.

6. Auditing Standard 2 includes guidance (paragraphs 198-199) on the auditor's responsibilities with respect to an auditor's report on management's assessment of internal control over financial reporting included in filings under the Federal securities statutes. We believe the SEC should clarify the filing requirements, if any, for an auditor's report on the elimination of a material weakness and the Proposed Standard

should address any additional auditor's responsibilities with respect to such reports that are filed.

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We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP