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

Via e-mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 018, *Reporting on the Elimination of a Material Weakness*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the proposed auditing standard, *Reporting on the Elimination of a Material Weakness*. We understand the Public Company Accounting Oversight Board's ("Board" or "PCAOB") desire to respond to those in the public markets who desire an update to the internal control audit results when material weaknesses are disclosed, but we have serious concerns about the misperception and improper conclusions such users may place on an engagement to report on the elimination of material weaknesses as set forth in this proposed standard. Further, we have concerns that this proposed standard could actually undermine Auditing Standard No. 2. These concerns with respect to the proposal are expressed below and in Appendix A, which contains our responses to the questions put forward by the Board. Additional paragraph-level comments are presented in Appendix B.

Objective of the Engagement

The auditor's objective in an engagement to report on the elimination of a material weakness is to express an opinion on whether the company has eliminated a previously reported material weakness (paragraph 4). To obtain reasonable assurance, the auditor should obtain and evaluate evidence about whether specified controls were designed and operating effectively as of the date specified by management and whether those controls satisfy the company's stated control objective (paragraph 6). The auditor's opinion is on whether the identified material weakness was eliminated as of the date of management's assertion because the stated control objective is met as of the date of management's assertion (paragraph 47n).

We do not believe that the nature and extent of the evidence to be obtained, as specified in paragraph 6, will be sufficient to meet the objective as stated in paragraph 4 and, as a result, it would not support the opinion described in paragraph 47n.

According to the briefing paper, the proposed standard anticipates that the auditor's testing would be limited to the controls specifically identified by management as eliminating the material weakness. This concept is reiterated throughout the proposed standard (beginning with paragraph 6). However, many controls address more than one control objective, and many control objectives are addressed by more than one control (either overlapping or complimentary). Given the nature of internal controls, it would be inappropriate for the auditor to assume that all controls that were previously implemented and reported on as operating effectively are still operating effectively. Unless the auditor conducts an audit of all significant and relevant controls designed to address a specified control objective, we believe that it would be inappropriate to state that a material weakness has been eliminated. We believe that the wording of the objective in the proposed standard would imply to the users of the auditor's report a broader scope of assurance than is intended.

We believe that the objective in the proposed engagement should be to express an opinion on management's assertion that specified controls designed to meet the specified control objectives have been implemented and that they are operating effectively. The auditor's opinion should reflect this objective and state that, if other controls not tested in this examination still operate effectively, the result would be that the material weakness is eliminated.

The Integrated Audit

We understand and appreciate the reason why Auditing Standard No. 2 requires an integrated audit of the financial statements and internal control over financial reporting: each audit provides the auditor with information relevant to the auditor's evaluation of the results of the other audit. In fact, our experience in the most recent audit season showed that most material weaknesses in internal control were identified by performing substantive audit procedures. Given this premise, we have some concerns about the auditor reporting on eliminating a material weakness as a stand-alone engagement, even when the auditor has performed the integrated audit within the past year. We believe these concerns might be alleviated if the proposed standard strongly encouraged the auditor to perform substantive audit procedures in connection with this proposed engagement. The option to perform substantive procedures is provided for in paragraph 31 of the proposed standard; however, given the value of substantive audit procedures in identifying material weaknesses, we believe that paragraph 31 should be strengthened by requiring the auditor to consider performing such procedures.

We agree with paragraph 30 of the proposed standard, which acknowledges that it would take longer for the auditor to obtain sufficient evidence as to the operating effectiveness of pervasive, company-level controls than of transaction-based controls. In fact, we believe that it would be very difficult and costly for the auditor who is not performing an integrated audit, to obtain evidence of operating effectiveness of a pervasive control in a timely manner to make reporting on remediation meaningful. For example, if the material weaknesses were related to the lack of effectiveness of the audit committee, it may not be appropriate for the auditor to report on the operating effectiveness of that control without doing an integrated audit. On the other hand, information technology general controls and process or transaction-level controls are very conducive to testing.

We believe that the proposed standard should be very clear as to the differences between these types of controls, including the different approaches that the auditor would have to take to test them. We further believe that the standard should emphasize, in the case where the auditor has been asked to report on operating effectiveness of a pervasive, or company-level control, the need to consider: (a) whether the auditor will be able to obtain sufficient understanding of the control; (b) whether the auditor will be able to obtain sufficient evidence regarding the operating effectiveness of the control; and (c) whether the control has been in operation for an adequate period of time in order for the auditor to determine the operating effectiveness of the control. We believe auditors should apply the same criteria for determining operating effectiveness of controls in this proposed engagement as they would for determining operating effectiveness in an integrated audit performed under Auditing Standard No. 2.

The auditor who has not performed the integrated audit within the past year is even a step further away from understanding the full picture, as anticipated by Auditing Standard No. 2. If the proposed standard does not have substantial additional clarity with respect to the necessary requirements to conduct to conduct an engagement of this nature, we question whether it is in the public interest for a newly-engaged auditor, who has not performed the integrated audit within the past year, to perform the proposed engagement as described in paragraphs 2 and 23. Therefore, similar to our recommendations related to the auditor who has been asked to report on the operating effectiveness of a pervasive, or company-level control, we believe that the standard should emphasize, in the case where a newly-appointed auditor has been asked to report on the operating effectiveness of a control, the need to consider: (a) whether the auditor will be able to obtain sufficient understanding of the control; (b) whether the auditor will be able to obtain sufficient evidence regarding the operating effectiveness of the control; and (c) whether the control has been in operation for an adequate period of time in order for the auditor to determine the operating effectiveness of the control.

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We would be pleased to discuss any of our comments with you. If you have any questions, please contact Mr.. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,

Grant Thornton LLP

Appendix A – Responses to Questions

Questions Regarding Reporting on the Elimination of a Material Weakness

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?

   We believe that there is potential for considerable confusion in the market place regarding this proposed engagement. It is imperative that the auditor's report be very clear. We have concerns regarding the following aspects of the sample auditor's report:

   - The sample report includes an opinion on whether the identified material weakness has been eliminated as of the date of management's assertion because the stated control objective is met as of the date of management's assertion. As noted in our cover letter, we believe that the scope of the engagement described in paragraph 6 would not provide the auditor with the assurance necessary to form such an opinion. We believe that the auditor should express an opinion on management's assertion that specified controls designed to meet the specified control objectives have been implemented and that they are operating effectively. The opinion should state further that, if other controls not tested in this examination still operate effectively, the result would be that the material weakness is eliminated.

   - The sample report includes a statement that the engagement includes obtaining an understanding of internal control over financial reporting. As noted in our comments on paragraph 47l, in Appendix B, we question whether such a statement would be misleading to the users of the auditor's report. In fact, this engagement only contemplates obtaining an understanding of the specified controls and relying on previously obtained understanding over other controls. Controls that have previously been implemented and reported on as operating effectively may not be operating effectively at the time this proposed engagement is performed.

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, should the proposed standard require the auditor's report to specifically identify the additional material weaknesses?

   We believe that, in the case where the auditor is not asked to report on all of the material weaknesses that were identified during the company's most recent audit of internal control, the proposed standard should require management to identify and the auditor to disclaim an opinion on the material weaknesses that are not addressed in the proposed engagement. The auditor's report should also disclaim an opinion on whether any other material weaknesses have developed.

   a. 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)?

      We believe that a requirement for management to identify and for the auditor to disclaim an opinion on those material weaknesses that were identified during the company's most recent audit of internal control, but are not being addressed by the proposed engagement would be helpful to report users. The disclaimer of opinion would clarify that the auditor does not know if those material weaknesses still exist or if any other material weaknesses have developed. We are most concerned about the user who sees only a "clean" report on the elimination of a selected material weakness and believes that all material weaknesses have been eliminated.

b. 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?

Specific identification of other material weaknesses not addressed by the auditor's report may, indeed, deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses were eliminated. While we understand that accurate information is in the best interest of the public, we also believe that complete information is also in the best interest of the public. To disconnect the "good" information from the "bad" information allows the company to "cherry pick" which material weaknesses it would like to eliminate, and may result in piecemeal opinions, which are confusing to readers and not in the public interest.

3. Should this standard allow an auditor to report on the elimination of a material weakness when such weakness was identified and eliminated as of an interim date (in other words, identified and eliminated without ever being addressed in the company's Section 404 reporting)?

If the description of the material weakness is adequately described in both management's and the auditor's reports, and the nature, timing and extent of the procedures that the auditor performs support his or her ability to express an opinion (see our comments on paragraph 6), there is no reason why the auditor should not be permitted to report on the elimination of a material weakness when such a weakness was identified as of an interim date and eliminated as of a subsequent date. This information may be beneficial to the audit committee or others who are responsible for corporate governance at the entity. We would, however, recommend reminding the auditor that the guidance in paragraph 30 of the proposed standard regarding the period of time needed to determine the operating effectiveness of a control applies.

Appendix B – Specific Paragraph-Level Comments

The following describes additional concerns and offers other substantive comments and/or suggestions relating to specific paragraphs.

- **Paragraph 2** – In our opinion, it would be very difficult and costly for an auditor to obtain the requisite basis for performing the proposed engagement without having performed an audit of the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2 within the past year. By allowing for this possibility as early as paragraph 2 in the proposed standard, there is an implication that this situation is ordinary. Please see our recommendations related to the newly-appointed auditor in our cover letter.

- **Paragraph 9 –** We agree that the definitions of the terms as defined in paragraph 9 should carry the same definitions as in Auditing Standard No. 2; however, it is also important to emphasize that internal control over the preparation of interim financial information may differ from internal control over the preparation of annual financial statements because certain accounting principles and practices used for interim financial information may differ from those used for the preparation of annual financial statements, for example, the use of estimated income tax rates for the preparation of interim financial information, which is prescribed by Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*.

- **Section on "Applying the Standards of the PCAOB" –** These are fundamental thoughts. We wonder if they might be better placed at the beginning of the document – even as early as just after the "Applicability of the Standard" section.

- **Paragraph 20** – The concept of materiality becomes difficult as this engagement is disconnected from the audit of the financial statements. Paragraph 23 of Auditing Standard No. 2 specifically ties together the concepts of materiality related to financial reporting and internal control over financial reporting. If the auditor is not simultaneously conducting the audit of financial statements, do the same concepts of materiality apply? We suggest that the proposed standard include further guidance on the concept of materiality as related to reporting on the elimination of a material weakness in internal control. We suggest that materiality should be that of the most recent audited financial statements.

- **Paragraph 23 –** In our comments on paragraph 2, we recommended additional guidance when a successor auditor is performing the proposed engagement as his or her initial engagement. We also have recommended additional guidance when any auditor is reporting on the operating effectiveness of a company-level control as described in paragraph 23a.

  In our comments on paragraph 6, we noted that the proposed engagement contemplates that the auditor will obtain reasonable assurance by obtaining and evaluating evidence about whether specified controls were designed and operating effectively, and whether those controls satisfy the company's stated objective. Paragraph 23a requires a newly appointed auditor to follow the guidance in paragraphs 47 through 51 of Auditing Standard No. 2, in order to report on the elimination of a material weakness. We note that these procedures go far beyond the scope of the proposed engagement, as described in paragraph 6. We believe that the objective of the engagement, the scope of the work described in paragraph 6, and the level of evidence and understanding necessary to achieve the objective of the engagement are not aligned.

- **Paragraph 37 –** We find paragraph 37 to be very confusing. Is the intent of this paragraph to allow the principal auditor to make reference, but disallow the division of responsibility on this proposed engagement? To us, the logic seems backwards. When the principal auditor relies on the work of an other auditor, the principal auditor should make reference to the work of the other auditor. If there is no reliance on another auditor's work, there is no need to make reference. Furthermore, it is not clear if the principal auditor discussed in this paragraph is the principal auditor of the annual integrated audit, or the principal auditor of this proposed engagement, or both.

- **Paragraph 47l –** We question whether the statement that the engagement includes obtaining an understanding of internal control over financial reporting would be misleading to the users of the auditor's report. In fact, this engagement only contemplates obtaining an understanding of the specified controls, and relying on previously obtained understanding over other controls. As previously stated in our cover letter, controls that have previously been implemented and reported on as operating effectively may not be operating effectively at the time this proposed engagement is performed.

- **Paragraph 54 –** We question what the auditor's reporting and communication responsibilities would be if, in reporting on the operating effectiveness of specified controls, the auditor becomes aware of other material weaknesses that were not disclosed previously. We believe that management should be required to disclose all material weaknesses, whether previously disclosed or not, and the auditor should disclaim an opinion on all material weaknesses not being addressed by the proposed engagement. We request additional guidance on this topic.