INSTITUT
DER
WIRTSCHAFTSPRÜFER
IDW

May 17, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609
USA

By E-Mail: rule-comments@sec.gov

Dear Sir(s):

Re: Release No. 34-49544; File No. PCAOB-2004-03

IDW Comments on PCAOB Rulemaking: Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

We would like to thank you for the opportunity to comment on PCAOB Rulemaking: Public Company Accounting Oversight Board: Notice of Filing of Proposed Rule on Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (Release No. 34-49544; File No. PCAOB-2004-03). The Institut der Wirtschaftsprüfer (IDW) represents approximately 85 % of the German Wirtschaftsprüfer (German Public Auditor) profession. The IDW is providing you with comments on the PCAOB's Proposed Rule noted above because we believe that this Proposed Rule will affect not only the development of auditing standards in the United States, but also influence auditing standards on internal control on a worldwide basis. Furthermore, a significant number of German Wirtschaftsprüfer are or will be subject to the requirements of the Sarbanes-Oxley Act.

Institut der Wirtschaftsprüfer
in Deutschland e.V.
Tersteegenstr. 14
40474 Düsseldorf
Postfach 320580
40420 Düsseldorf

Telefonzentrale 0211/4561-0
Fax Geschäftsleitung 0211/4541097
Fax Fachabteilung 0211/4561233
Fax Bibliothek 0211/4561204
Internet www.idw.de
E-Mail info@idw.de

Geschäftsführender Vorstand:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands
Dr. Gerhard Gross
Dr. Wolfgang Schaum, WP StB

Bankverbindung:
Deutsche Bank AG
Düsseldorf
BLZ 300 700 10
Kto. Nr. 7 480 213

General comments

We would first like to convey to you our appreciation towards the PCAOB for having taken on board, in the currently Proposed Rule filed with the SEC, the suggestion in our comment letter dated November 21, 2003 on PCAOB Rulemaking Docket Matter No. 008 (PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements) that the auditor provide separate opinions on management's assessment of the effectiveness of internal control and on the effectiveness of internal control directly. We were particularly pleased that the PCAOB took this suggestion on board in its Proposed Rule filed with the SEC, even though it appears that our comment letter may have been the only one that made this suggestion.

Nevertheless, we have chosen to provide our views on the Proposed Rule directly to the SEC because we believe that the Rule as currently proposed by the PCAOB appears to be inconsistent with the Securities and Exchange Act of 1934, and either sets requirements for management in relation to internal control (which we believe may be beyond the mandate of the PCAOB) or imposes responsibilities upon auditors in relation to control that exceed those of management (which we surmise may be incongruous with the relative roles of management and the auditors). To obtain additional details supporting our views as expressed in this letter, you may find it desirable to refer our comment letter to the PCAOB mentioned above, a copy of which we have attached for your convenience.

The Definition of Reasonable Assurance

PCAOB Definition vs. The Securities and Exchange Act of 1934 ("SEA")

Paragraph 17 of the Proposed Rule states

> "Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion. Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."

We note that, in contrast, 14 U.S.C. 78m(b)(7) – i.e., the Securities and Exchange Act of 1934 ("SEA") – defines reasonable assurance as "…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs". The SEC's Final

Rule "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" (Release No. 33-8238) effectively refers to both this definition in the SEA and that applied in auditing literature – neither of which speak of "remote likelihood".

Our first concern is that the PCAOB definition of reasonable assurance (a remote likelihood that material misstatements will not be prevented or detected on a timely basis; a high, but not absolute, level of assurance) appears to be inconsistent with the definition of reasonable assurance in the Securities and Exchange Act of 1934 (SEA) unless, by implication, one accepts the contention that prudent officials are *always* capable of reducing the likelihood of a material misstatement not being prevented or detected on a timely basis by means of controls to a *remote* level. To use more legalistic terminology, the PCAOB definition appears to contend that prudent officials are *always* able to use controls to obtain a burden of persuasion equivalent to a "*remote* likelihood of being wrong".

Analysis of the Definition of Reasonable Assurance

We believe such a contention to be spurious because in many circumstances controls (whether internal controls established by management or external controls operating through, for example, external audits) are not effective instruments in response to certain kinds of risks. In this vein, while we are not experts in U.S. law, it appears to us that the U.S. legal profession has always recognized that, in certain circumstances, the burden of persuasion may be limited because of the nature of the evidence available and hence accepts different burdens of persuasion for different kinds of decisions ("beyond any reasonable doubt" for criminal trials, "clear and convincing evidence" – which is often associated with reasonable certainty and high probability – and "the preponderance of the evidence" for most civil trials).

In our view, given the inherent limitations on the effectiveness of controls (and hence the limitations on the evidence that they can provide on whether or not a material misstatement exists) the burden of persuasion that can be obtained either by management or auditors in relation to some kinds of misstatement risks may be considerably less than "a remote likelihood". The term "remote likelihood" either appears to be cognate to "beyond any reasonable doubt" or may even exceed the burden of persuasion required in criminal cases. We believe that often controls may only prevent or detect a material error (and yield evidence to that effect) with "clear and convincing evidence" or "the preponderance of the evidence".

In this context, an example of a risk not susceptible to reduction through controls may be a complex sales contract used as the basis for determination of revenue recognition. Even after having obtained a legal opinion on the legal rights and obligations currently extant under the sales contract at year-end and having had accounting experts compare the terms of the contract to applicable accounting standards and practice, both the preparer of the financial statements and the auditor may find that, in their view, the weight of evidence supporting recognition under applicable accounting standards and practice may be only slightly greater than that not supporting recognition, or vice-versa. This situation is grey, rather than black and white. Yet, both the preparer and auditor must reach a decision on the matter. In these circumstances, for example, neither management nor the auditor can claim to have achieved a remote likelihood that a court, regulator, standards setter, professional body or other preparers or auditors will not take a different view (and perhaps even overturn their decision later). It is not unusual for competent individuals acting in good faith to disagree. In any case, there are other examples of misstatement risks that cannot be reduced to a remote likelihood of occurrence by means of control.

Hence, relating reasonable assurance just below absolute assurance or to a remote likelihood of a risk of material misstatement is fundamentally misleading. Both preparers and auditors face making many decisions that can only be made on the basis of what the legal profession terms “the preponderance of the evidence” or “clear and convincing evidence” as opposed to “beyond and reasonable doubt” or even a “remote likelihood of being wrong”. Consequently, we believe that the application of the test “remote likelihood of a material misstatement” is effectively inconsistent with the “reasonability test” in relation to “prudent officials” applied in the SEA.

In paragraph 16, the Proposed Rule does address inherent limitations of internal control, but only in the context of human diligence and compliance, and not in relation to the fact that some matters are inherently difficult to control or measure. In any case, the description of the limitations in internal control in that paragraph appears to be inconsistent with the contention implicated in paragraph 17, that prudent officials are *always* in a position to reduce the likelihood of a material misstatement not being prevented or detected on a timely basis by means of controls to a *remote* level.

Implications for Management and Auditors and a Solution

As noted in the analysis above, it is impossible for management to apply internal control such that all possible risks of material misstatement are reduced to a remote likelihood. By promoting this spurious contention, the Proposed Rule increases unrealistic expectations of users of financial statements in relation to the capabilities of management and auditors and thereby will reduce the credibility of the financial reporting process. Furthermore, by applying an unreasonable test (“remote likelihood of a material misstatement”), it is likely that the Proposed Rule will cause the potential liability risk for both management and auditors in relation to internal control to become disproportionate to the actual ability of management and auditors to reduce the likelihood of material misstatements.

In our view, more appropriate solutions to defining reasonable assurance would be to either: 1. not attempt to define reasonable assurance beyond the definition provided in the SEA or 2. define reasonable assurance in relation to an acceptably low level of risk of material misstatement. Both solutions recognize that the actual level of assurance reasonably achievable depends upon the circumstances – that is, the test to be applied is one of reasonability in the circumstances for prudent officials.

Requirements in Relation to Management or Greater Auditor Responsibilities

The definition of "reasonable assurance" noted above as described in paragraph 17 of the Proposed Rule refers to "management's [underlining added] assessment of the effectiveness of internal control over financial reporting" as being expressed at the level of reasonable assurance and notes that the definition of reasonable assurance is "built into the definition of internal control over financial reporting". The paragraph then goes on to define reasonable assurance in terms of "a remote likelihood that material misstatements will not be prevented or detected on a timely basis" and as being a high, but not absolute, level of assurance.

On this basis, it appears that the PCAOB's Proposed Rule is defining reasonable assurance in relation to internal control for both management and auditors. While we are not legal experts in the application of the Sarbanes-Oxley Act ("SOA"), it appears to us that defining "reasonable assurance" in relation to internal control for management purposes exceeds the mandate of the PCAOB as defined in Section 101 (b) of the SOA, which appears to limit the mandate of the PCAOB to rules governing auditors and audits. We ask ourselves whether it was the intent of the wording in Section 101 (a) "and related matters" and the wording in Section 101 (c) (5) that the competence of the PCAOB be extended to issuing rules directly applicable to SEC registrants in relation to matters that are already being regulated directly through the SEC (i.e., through the SEC's Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports; Release No. 33-8238). Certainly, the Note in paragraph 2 of the PCAOB's Proposed Rule suggests that the PCAOB does not intend to create new requirements in addition to SEC requirements for SEC registrants or to interpret legal requirements imposed by the SEC on SEC registrants.

If the SEC believes that the PCAOB can and should issue rules that apply directly to SEC registrants, then the scope of paragraph 17 in the Proposed Rule is not problematic. On the other hand, if the PCAOB's competence extends only to the issuance of rules over auditors and audits, then the contents of paragraph 17 would apply to audits of internal control, but not to internal controls as established by management.

As we pointed out above in the previous section on the problems with the definition of "reasonable assurance", the definition in paragraph 17 appears to be inconsistent with and exceeds the stringency of the definition in the SEA and Release No. 33-8238. In our view, it would be – at least – unusual for Rules applying to audits of internal control to require greater stringency in the audit of an internal control system than the rules applied in establishing the effectiveness of the internal control system. In other words, we have difficulty understanding how reasonable assurance for an audit of internal control as defined by the PCAOB ("remote likelihood") would appear to require a more severe test than the rules of the SEC for the effectiveness of the internal control system established by management ("prudent officials"). In our view, this is not a tenable position.

On this basis, it appears that it may be advantageous for the PCAOB to align its definition of reasonable assurance for audits of internal control with the definition in the SEA as we describe in the previous section of our comment letter.

The Definition of Significant Deficiency

Paragraph 8 defines significant deficiency as follows:

> "A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected."

The use of the term "remote likelihood" is referred by footnote 5 to paragraph 3 of FASB Statement No. 5 Accounting for Contingencies (FAS No. 5), which defines the terms probable, reasonably probable and remote for events in relation to contingencies.

As we have pointed out in our discussion on reasonable assurance, the application of controls, assessments or audits will not necessarily enable an increase in assurance nor a concomitant decrease in the risk that a material misstatement occurs in some

INSTITUT
DER
WIRTSCHAFTSPRÜFER
IDW

circumstances. Consequently, we question whether it is appropriate to apply, in all circumstances, the standard of “more than a remote likelihood” in relation to the degree to which controls should be able to prevent or detect a material misstatement.

In this matter, it should be noted that the application of the probability concepts (probable, reasonably probable and remote) to evaluate events leading to loss contingencies is an entirely different matter than using these probability concepts in determining the likelihood (what level of assurance has been obtained) that the appropriate probability concept was chosen, which is what is being asked of the internal control system, and hence of management’s assessment and of the auditors. Consequently, the application of the concept “remote” can only lead to situations where management or the auditors (or both) are blamed for situations beyond their control.

Consequently, we suggest that a significant deficiency be defined as:

> “a control deficiency, or combination of control deficiencies, that adversely affects a company’s ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that management obtains reasonable assurance that a misstatement in the annual or interim financial statements that is more than inconsequential will be prevented or detected”.

The level of risk covered by “reasonable assurance” is an issue that we address in the previous sections of this comment letter.

Of course, such a change in the definition of a significant deficiency means that the definition of a material weakness ought to be amended accordingly.

We hope you find our comments helpful and would be pleased to be of assistance to you if you have any questions about these comments.

Yours very truly,

signed Dr. Gerhard Gross
Executive Director

signed Wolfgang P. Böhm
Special Advisor to the Executive Board

494/538

INSTITUT
DER
WIRTSCHAFTSPRÜFER

IDW

Düsseldorf, November 21, 2003

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

USA

By E-Mail: comments@pcaobus.org

Dear Sir(s):

Re: PCAOB Rulemaking Docket Matter No. 008
IDW Comments on the PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

We would like to thank you for the opportunity to comment on the PCAOB Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. The Institut der Wirtschaftsprüfer (IDW) represents approximately 85 % of the German Wirtschaftsprüfer (German Public Auditor) profession. The IDW seeks to comment on the proposals by the PCAOB noted above because we believe that this Proposed Rule will affect not only the development of auditing standards in the United States, but also influence auditing standards on internal control on a worldwide basis. Furthermore, a significant number of German Wirtschaftsprüfer are or will be subject to the requirements of the Sarbanes-Oxley Act.

General comments

Comment Period

We were disappointed to see the very short exposure period in which comments can be provided to the PCAOB. A comment period of 45 days is too short for a standard

Institut der Wirtschaftsprüfer
in Deutschland e.V.
Tersteegenstr. 14
40474 Düsseldorf
Postfach 320580
40420 Düsseldorf

Telefonzentrale 0211/4561-0
Fax Geschäftsleitung 0211/4541097
Fax Fachabteilung 0211/4561233
Fax Bibliothek 0211/4561204
Internet http://www.idw.de
E-Mail info@idw.de

Geschäftsführender Vorstand:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands
Dr. Gerhard Gross
Dipl.-Kfm. Peter Marks, WP StB

Bankverbindung:
Deutsche Bank AG
Düsseldorf
BLZ 300 700 10
Kto. Nr. 7 480 213

of such length and importance in an international environment, since many organizations would like to have the opportunity to consult with their stakeholders. We would suggest that 90 days might be more appropriate for longer proposed standards of greater complexity, such as this one.

We are convinced that, if we had had the opportunity to consult our stakeholders and analyze this standard with greater diligence, we would have found additional significant issues that might require your attention.

Comments on Particular Technical Matters

The Audit Opinions Required

Section 404 of the Sarbanes-Oxley Act (SOX) requires the annual report " …to contain an internal control report, which shall … contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Furthermore, …"each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer". Section 103 states that the Board "…shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall … describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer required by Section 404 (b), *and* [italics added] present (in such report or in a separate report) (I) the findings of the auditor from such testing; (II) an evaluation of whether such internal control structures and procedures … ." Based on the wording in Section 103(2)(A)(iii), it appears to us that two opinions are being required of the auditor in relation to internal control: one on management's assessment and one on internal control directly.

We would like to point out that, contrary to the view expressed in footnote 3 of the proposed standard, an "audit of internal control over financial reporting" is not the same as "attestation of management's assessment of the effectiveness of internal control over financial reporting", nor does the former just refer to the process and the latter to the result of that process. We will provide our reasons for this assertion in the following paragraphs.

Presumably, management's assessment of the effectiveness of internal control would have to have the same scope (and cover the same period) as an audit of internal control performed by an independent third party so that management's assessment can be expressed at the level of reasonable assurance as described in paragraph 16 of the standard (this appears to be consistent with our reading of the requirements for management's assessment under the SEC's Release No. 33-8238 on Management's

Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports). This means that there is some residual risk that management's assessment had been appropriately performed but concludes that the internal control system is effective, even though it is not (the risk of incorrect acceptance). Hence, an independent auditor's attestation of management's assessment may conclude that management's assessment was appropriately performed, even though the internal control system is not effective.

This is different from the situation in which the independent auditor reaches an independent conclusion as to whether the internal control system is effective because, even thought the scope of the audit performed by the auditor may be the same as the assessment conducted by management, the auditor may, for example, choose different sample items on a random basis and thereby come to different conclusion than management.

In other words, we believe that SOX actually requires three separate opinions by the auditor: 1. on the fairness of the financial statements, 2. on the assessment of the effectiveness of internal control made by management and 3. on the effectiveness of the internal control. While these opinions may be closely related, they need not, by any means, lead to the same conclusion in all circumstances. For example, because internal controls only provide reasonable assurance that material misstatements will be prevented or detected on a timely basis, both management and the auditor may conclude that internal control is functioning effectively even though management or the auditor detect a material error in the financial statements by means other than the functioning of the internal control system. Likewise, in situations where the internal control system is not operating effectively and the audit of the internal control system by the auditor detects this, management may have appropriately conducted its assessment of the internal control system and concluded that the internal control system is operating effectively. Other combinations of opinions are conceivable. However, we suspect that some combinations will not be as relevant as others. For example, if management's assessment came to the conclusion that internal control is not effective, the auditor will examine the basis for that conclusion and it is very unlikely that he or she will reach a conclusion that is at variance with that of management in this case.

While the SEC's Release No. 33-8238 only addresses the auditor's opinion on management's assessment of the effectiveness of internal control, we believe that this does not preclude the PCAOB from requiring an opinion on internal control by the auditor beyond an opinion on management's assessment. The current draft standard is based on merging the opinion by the auditor on management's assessment of internal control with the opinion by the auditor on the effectiveness of internal control.

In our view, this approach is fundamentally flawed for the reasons given above. We therefore recommend that the standard be amended to provide for the auditor expressing three separate opinions, as noted in the previous paragraph. Furthermore, the standard should make clear that management's assessment should have the same scope (and cover the same time period) as an audit of internal control performed by an independent third party.

Reasonable Assurance

Paragraph 16 of the proposed standard states

> "Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion. Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."

We are disappointed that the PCAOB is attempting to address a concept as fundamental, complex and important as the meaning of "reasonable assurance" as an "afterthought" within the confines of a proposed operational standard without having properly analyzed the issues surrounding the use of the term or exposed a separate issues or discussion paper to allow stakeholders adequate input before standards or rules dealing with fundamental auditing issues are proposed in this regard. We are particularly disappointed in this respect because we are aware that the AICPA had requested the PCAOB on more than one occasion in writing to commence a project on the meaning of "reasonable assurance".

With respect to the meaning of reasonable assurance, footnote 7 in the proposed standard refers to the "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003)" for further discussion of reasonable assurance. Our review of this Rule indicates that the term "reasonable assurance" is addressed primarily in "II. Discussion of Amendments Implementing Section 404", "F. Periodic Disclosure about the Certifying Officer's Evaluation of the Company's Disclosure Controls and Procedures and Disclosure about Changes to its Internal Control over Financial Reporting", "4. Conclusions Regarding Effectiveness of Disclosure Controls and Procedures". In this Rule reasonable assurance is not defined: rather, footnotes 101 and 102 make reference to Section 13(b)(2) of the Exchange Act (15 U.S.C. 78m(b)(2)) and the Codification of Statement on Auditing Standards AU §319.18, respectively.

We believe that the reference to AU §319.18 is erroneous: the concept of reasonable assurance in relation to internal control is actually discussed in AU§ 319.21 to .24. In any case, the discussion of reasonable assurance in relation to internal control in AU §319 does not speak of "relatively low risk that material misstatements will not be prevented or detected", nor suggest that reasonable assurance represents a "high level of assurance". Rather this part of the AU §319 actually discusses the limitations of an entity's internal controls and cost-benefit relationships, etc. We also note that the AICPA standard on performing attest engagements on internal control (AT §501) refers to neither reasonable assurance nor high assurance, but does discuss the inherent limitations of internal control.

Based on our reading, 15 U.S.C. 78m(b)(2) actually only refers to the provision of reasonable assurance by the internal control system without defining it. We note that 14 U.S.C. 78m(b)(7) defines reasonable assurance as "…the degree of assurance as would satisfy prudent officials in the conduct of their own affairs". There is no mention of "relatively low risk" or "high assurance".

We would like to point out that the issues surrounding the meaning of "reasonable assurance" are both politically and technically very complex and a treatise on the subject could fill volumes. In this respect we would like to refer to the discussion on the meaning of assurance and levels of assurance in the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements". Nevertheless there is one issue that deserves mention to help focus on the practical problems involved.

Because audit or assessment risk is not separable from the uncertainties associated with the application of criteria to the subject matter, high inherent risks often cannot be alleviated through controls or an assessment or audit. This problem is often termed "consilience" by academics.

For example, a complex sales contract may be the basis for the determination of revenue recognition. Even after having obtained a legal opinion on the legal rights and obligations currently extant under the contract at year-end, both the preparer of the financial statements and the auditor may find that, in their view, the weight of evidence supporting recognition under applicable accounting standards is only slightly greater than that not supporting recognition: the situation is grey rather than black and white. Yet, both the preparer and auditor must reach a decision on the matter. In these circumstances, for example, neither can claim to have achieved a high level of assurance that, on balance, at least a slight majority of preparers and auditors would have agreed with their decision or that they had reduced the converse to a relative low level of risk (in measurement theory, this is known as the “equivalence” aspect of reliability).

Hence, relating reasonable assurance to high or to just below absolute assurance or to relatively low risk is fundamentally misleading because both preparers and auditors face many decisions that can only be made on the basis of what the legal profession terms “the preponderance of the evidence”. This thought ties in to the concept that audit evidence is persuasive rather than conclusive or convincing.

The other main problem with the application of the reasonable assurance concept as currently suggested by the draft standard is the tendency for third parties to apply 20-20 hindsight to the concept of reasonableness. In other words, third parties (neither management nor the auditors) will tend to take the view that if a catastrophe occurs, then the controls that were designed and implemented to prevent that catastrophe could not have been reasonable or reasonably effective. This stance, which is in itself unreasonable, can only be countered by a technically and politically sound treatment of the meaning of reasonable assurance.

The definition of reasonable assurance also ties into the definition of a “significant deficiency”, which we will address in the following section.

The definition of significant deficiency

Paragraph 8 defines significant deficiency as follows:

> “A *significant deficiency* is an internal control deficiency that adversely affects the company’s ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in a more than remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.”

The use of the term “remote likelihood” is referred by footnote 5 to paragraph 3 of FASB Statement No. 5 Accounting for Contingencies (FAS No. 5), which defines the terms probable, reasonably probable and remote for events in relation to contingencies.

As we have pointed out in our discussion on reasonable assurance, the consilience between audit risk and the uncertainties associated with the application of criteria (accounting standards) to subject matter (events and circumstances) often reduces preparers and auditors to obtaining only a preponderance of the evidence to support decisions they have made with respect to the application of accounting principles in particular circumstances. In these circumstances, the application of controls, assessments or audits will not necessarily enable an increase in assurance nor a concomitant decrease in the risk that a material misstatement occurs. Consequently, we question whether it is appropriate to apply the standard of “more than a remote likelihood” that controls should be able to prevent or detect a material misstatement in all circumstances.

In this matter, it should be noted that the application of the probability concepts (probable, reasonably probable and remote) to evaluate events leading to loss contingencies is an entirely different matter than using these probability concepts in determining the likelihood (what level of assurance has been obtained) that the appropriate probability concept was chosen, which is what is being asked of the internal control system, and hence of management’s assessment and the auditors. Consequently, the application of the concept “remote” can only lead to situations where management or the auditors (or both) are blamed for situations beyond their control.

In this connection, we would like to point out that the term “remote” also has legal meaning that suggests its application for identifying significant deficiencies in internal controls is inappropriate (e.g., “remote possibility”, which refers to a limitation dependent upon two or more facts or events that are contingent and uncertain, or a double possibility). Another legal meaning relates possibilities to the burden of persuasion required in criminal courts of law: beyond any reasonable doubt, which is defined as “ … not a mere possible doubt; because every thing relating to human affairs, and depending upon moral evidence, is open to some possible or imaginary doubt” (Commonwealth v. Webster, 59 Mass. (5 Cush.) 295, 320 (1850)). On this basis a remote possibility represents a standard either higher than or equivalent to beyond any reasonable doubt, which, in turn, is a standard usually higher than that expected either of internal control, management assessments, or audits.

Consequently, we suggest that a significant deficiency be defined as “an internal control deficiency, that either singly or in combination with other deficiencies, adversely affects a company’s ability to initiate, record, process or report external financial data reliably in accordance with generally accepted accounting principles and thereby hinders management from obtaining reasonable assurance that a misstatement that is more than inconsequential in terms of the annual or interim financial statements will not be prevented or detected”.

Of course, such a change in the definition of a significant deficiency means that the definition of a material weakness ought to be amended accordingly.

Effectiveness

Both management's assessment and the auditor's opinion (on the assessment and on the internal control system) are in relation to the effectiveness of the internal control over financial reporting. While the concept of reasonable assurance that material misstatements will be prevented or detected on a timely basis is a useful standard, in practice, both management and auditors will require concrete effectiveness criteria. We would like to point out that it is a basic tenant of both assurance engagements (see ISA 100) and attest engagements (see AT §101) that criteria must be suitable before an assurance or attest engagement can be performed. In our view, the lack of suitable effectiveness criteria in this standard for internal control precludes the performance of a meaningful assessment by management and hence audit of effectiveness of internal control.

The Use of Work of Management and Others

While we agree, to the extent the auditor must form his or her own opinion, that tests performed by the auditor cannot be replaced by tests performed by management and others, we consider it to be dysfunctional to not allow the auditor to use information obtained from the work of management and others in designing and performing the auditor's work. For example, management may have detected a weakness in internal control. It would be dysfunctional for the auditor not to be in a position to apply a risk-based approach and use the information, obtained by management or others, that there may be greater risks in some areas, to the extent that the auditor has evidence to support the view that the work can be relied upon. In any case, because the auditor is expressing an opinion on management's assessment of internal control, the auditor is in a position to obtain evidence to support whether management's work in this regard is reliable.

IT-related controls

In our view, the proposed standard does not provide enough guidance with respect to IT-related controls. For example, in Example B1 of Appendix B (Daily Programmed Application control and Daily Information Technology-Dependent Manual Control), it is suggested that the auditor is in a position to conclude that computer controls operate in a systematic manner. In our view, the procedures performed by the auditor prior to the walk-through do not support such a conclusion. For example, in addition to the procedures mentioned, the auditor should have obtained some evidence to support conclusions with respect to relevant IT security controls (e.g., how does the system ensure that during the filing of information by the bank to the company others

INSTITUT
DER
WIRTSCHAFTSPRÜFER
IDW

do not obtain information that they are not authorized to have, authorization checks to ensure that the bank rather than some other person or entity communicated that information, and other procedures to address privacy risks, etc.). Beside the risks arising in an e-business environment, in principle, computer aided commercial activities that are automatically interfaced with the entities accounting system affect assets or liabilities, results or expenses or income or lead to events requiring disclosures in the financial statements. Therefore, the reliability of accounting information depends on the reliability of the IT-aided transactions. The auditor has to assess the reliability and security of IT-aided transactions processing based on principles for appropriate accounting information processing (further guidelines with respect to this issue are provided by IFAC in; "E-Business and the Accountant: Risk Management to Accounting Systems in an E-publication Environment").

We hope you find our comments helpful and would be pleased to be of assistance to you if you have any questions about these comments.

Yours very truly,

Klaus Peter Naumann
Chief Executive Officer

Horst Kreisel
Technical Manager

495/532