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By E-mail: [comments@pcaobus.org](mailto:comments@pcaobus.org)

February 26, 2007

Dear Sir(s)/Mme(s):

**Re.: PCAOB Rulemaking Docket No. 021  
PCAOB Release No. 2006-007, December 19, 2006**

**Proposed Auditing Standard –  
An Audit of Internal Control Over Financial Reporting That is Inte-  
grated with an Audit of Financial Statements  
And Related Other Proposals**

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany] (IDW) is pleased to have the opportunity to comment on the above-mentioned Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, And Related Other Proposals (hereinafter referred to as the “proposed PCAOB auditing standard” or “proposed standard”).

The IDW represents the profession of public auditors in Germany and is seeking to comment on the proposed PCAOB auditing standard because a significant number of IDW members audit, or are involved in the audit of, SEC-Registrants or German subsidiaries of such registrants, and are therefore affected by the proposed standard, if adopted. Furthermore, these members will also be indirectly affected by the Securities and Exchange Commission’s proposed interpretative guidance for management regarding its evaluation of internal control over financial reporting and the related proposed rule amendments in the document

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entitled “Management’s Report on Internal Control Over Financial Reporting” (hereinafter referred to as the “proposed management guidance”), that represents the SEC’s proposed management guidance counterpart to the proposed PCAOB auditing standard. Many of our comments are made in light of the relationship between these two documents and we therefore refer the PCAOB to our comment letter to the SEC on the proposed management guidance, which is attached for your reference.

Our letter contains matters of general concern. Further matters of specific concern and more detailed analyses are addressed in the Appendix to this letter.

## **General Matters**

### **Comment period**

We are pleased to note that the SEC and PCAOB have aligned their periods of exposure for the proposed management guidance and the proposed PCAOB auditing standard. However, we are disappointed to see the short exposure period in which comments can be provided to the SEC and PCAOB, particularly since both bodies published their proposals immediately prior to the Christmas holiday season and many organizations would like to have the opportunity to consult more thoroughly with their stakeholders. Due to the rather short comment period, we have only been able to “scratch the surface” in terms of the issues contained in the proposed PCAOB auditing standard.

### **Overall comments**

We appreciate the initiative taken by both the SEC and the PCAOB to revisit the issue of internal control over financial reporting from both management and auditor perspectives and the effort made to align the two documents. In previous comment letters to the PCAOB and the SEC, we had noted a number of issues in the then proposed PCAOB auditing standard AS-2, and have most recently commented on the SEC’s concept release that we support the issuance of guidance for management. We continue to believe that there is a need for principles-based requirements, and guidance, on management’s design, implementation and operation of internal control over financial reporting, as well as for the performance of management’s assessment of that internal control.

In particular, as a matter of principle (though not necessarily the manner proposed), we support the

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- top-down approach to determine which controls are the most significant and which of lesser significance,
- emphasis that has been placed on assessment of the risk of material misstatement,
- increased emphasis on professional judgment (rather than check-list mentality),
- approach to first consider general controls, and then application controls,
- introduction of SME guidance

However, we have serious concerns about the way in which these matters have been implemented in the proposed standard – in particular, the disconnect between the proposed PCAOB auditing standard and the proposed management guidance and some of the internal logical inconsistencies within the proposed PCAOB auditing standard. In particular, we also have the following concerns:

- the flexibility allowed in the approach to assessing internal control, for management, as no one way or method is prescribed, but the comparative lack of flexibility for the auditor. This will not allow for significant cost savings
- the authority of an auditing standard is higher than that of guidance for management, which means that the auditors are subject to requirements when auditing internal control, whereas management need only consult guidance when performing its assessment without being subject to any requirements
- the guidance proposed by the SEC for management's approach to assessing internal control is far less detailed and stringent than that in the proposed PCAOB auditing standard
- the standard does not reflect fairly the increasing degree to which controls are automated, e.g., embedded controls. There should be more scope for auditors to reduce their work effort as appropriate.

The impetus to amend or replace AS-2 appears to have been twofold: 1. the desire to align any new auditing standard with the newly proposed management guidance, and 2. the desire to ensure that audits of internal control are carried out efficiently to reduce unnecessary costs and burdens. We believe that, in

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light of the proposed guidance, the proposed PCAOB auditing standard will not meet the first objective, and that there is a danger that the proposed guidance will not achieve the second objective.

*Proposed management guidance vs. PCAOB internal control standard*

The Commission has emphasized “that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures”.<sup>1</sup> We agree with this emphasis. However, the proposed management guidance allows management greater flexibility in carrying out its assessment of internal control over financial reporting than the proposed PCAOB auditing standard allows the auditor in auditing that internal control: the requirements and guidance in the proposed PCAOB auditing standard are more precise and stringent, allow less flexibility, and are in greater detail, than in the proposed management guidance. For example, the management guidance on company-level controls (page 25 et seq.) is far less detailed than that for the auditor (proposed AS-5 paragraphs 17-23). Another example is the fact that walk-through tests are required in the audit of internal control, but not for management’s assessment of internal control.

This disconnect between the proposed management guidance and the proposed PCAOB auditing standard will inevitably lead to auditors auditing internal control over financial reporting using the more stringent criteria in the proposed auditing standard, than those applied by management in designing, implementing, operating and assessing that internal control, because PCAOB enforcement activities will drive auditors to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. Consequently, auditors would be placed into the position of pressuring management to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. If management were to apply the more stringent requirements in the auditing standard, then the first objective for issuing the proposed management guidance ( i.e., the desire that management’s design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard – see our comment letter on the proposed management guidance) will not be achieved. If management were not to do so on the basis that they are not required to do so by the proposed management

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<sup>1</sup>SEC, Management’s Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 8

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guidance, auditors would apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard to the internal control system when management does not, and hence the first objective for issuing the new proposed PCAOB auditing standard (see above – i.e., the desire to align the auditing standard with the new proposed management guidance). Furthermore, this situation would lead to the inference that the auditor is taking greater responsibility for internal control than management is. This also appears to violate the fact emphasized by the SEC that management – not the auditor – is responsible for internal control.

The fact that the proposed management guidance allows management such a high degree of flexibility in performing its management assessment when the proposed PCAOB auditing standard does not for the auditor when auditing internal control also begs the question as to whether “reasonable assurance” for management is the same as “reasonable assurance” for the auditor (see discussion of reasonable assurance below). If they are the same, then the nature and extent of management’s assessment ought to be at least the same as the nature and extent of the audit of internal control by the auditor (with of course, the exception of the auditor’s procedures on management’s assessment). If they are not (i.e, if management obtains less assurance than the auditor), then this again appears to violate the fact that management bears greater responsibility for internal control over financial reporting than the auditor.

#### *Reduction of costs and burdens*

The proposed management guidance together with the proposed PCAOB auditing standard anticipate cost savings, both for the entity directly and indirectly in respect of consulting and audit fees.

We believe that a significant part of the costs of implementing management’s assessment and of AS-2 result from the fact that many entities do not possess sufficient documentation of their internal control. Consequently, companies require significant consulting from outside parties on the basis of AS-2 to document controls so that they are in a position to perform management’s assessment of internal control, and so that auditors can audit internal control. Furthermore, auditors provide considerable advice on what would constitute effective internal control over financial reporting for the purposes of the audit based upon the detailed requirements and guidance in AS-2. Only when management has designed, implemented and is operating well-documented internal controls and has performed a well-documented assessment of those controls can audit costs be reduced. Nevertheless, even though the proposed PCAOB auditing standard

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represents a considerable reduction in the degree of detail when compared to AS-2, it is unlikely to radically affect the audit procedures in total, as the overall requirements have effectively not been reduced: the cost of documenting, and obtaining consulting on, internal control changes, management's assessment, and the audit of internal control will remain greater than anticipated by the proposed management guidance and the proposed PCAOB auditing standard because, as a whole, no effective reduction in the stringency of the requirements for management's assessment or the audit of internal control has taken place (see the discussion on "reasonable assurance" below.)

In this context, we note that shortcomings revealed by PCAOB inspections did not indicate an "over-audit" of internal control, but discussed aspects where not enough audit work had been performed. Thus auditor's will still be driven by the need to perform sufficient work to satisfy PCAOB inspections.

The suggested removal of the need for auditors to provide an opinion on management's assessment is supposed to reduce unnecessary duplication of work. However, given that management's assessment process constitutes an internal control over financial reporting from the auditor's point of view, auditors would have based part of their audit work on examining that assessment in any case. Consequently, the elimination of an opinion on management's assessment will not lead to cost savings that are as great as anticipated.

*The proposed auditing standard on considering and using the work of others in an audit*

Certain aspects of the proposed new auditing standard on "considering and using the work of others" may have a negative impact on audit quality, given that, in contrast to an auditor's own staff, staff of an audit client will always be subject to a conflict of interest and may not have been trained appropriately to perform such work. We discuss this issue further in section 7 of the Appendix.

**Reasonable assurance and material weaknesses in internal control**

We refer to section 4 in the Appendix for a brief outline of the problems with the current definitions of "reasonable assurance" and "material weakness in internal control" in AS-2, for a detailed examination of the actual meaning of the change in definition included in the proposed PCAOB auditing standard (and the proposed management guidance also), and for an analysis of the implications. **This analysis shows that no effective change has taken place in the meaning of**

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**either “reasonable assurance” or “material weakness in internal control”:  
The proposed definition means that reasonable assurance that the ICFR is reliable is achieved when the likelihood that a material misstatement will not be prevented or detected by the ICFR is *remote*.**

We would like to point out that the effective use of a *remote* likelihood of risk as a threshold for reasonable assurance (for the reliability of internal control, for management’s assessment, and for the audit of internal control) will drive the nature and extent of the design and operation of internal control, management’s assessment of internal control and the audit of internal control. The flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to any significant reduction in the work effort of management or the auditor (and any significant reduction in costs) as long as this threshold drives their work.

We recommend that the SEC and the PCAOB adopt one definition of reasonable assurance that also forms the basis for the definition of material weakness as noted in section 4 in the Appendix.

## Concluding Comments

In our view, based on the comments above and in section 2 in the Appendix, the approach taken by the SEC and the PCAOB ought to have been reversed from what has taken, and is taking, place. In other words, what is needed, first and foremost, are principles-based standards, and guidance, for management on the **design, implementation, and operation** of effective internal control over financial reporting, including **suitable effectiveness criteria** for, and **documentation** of, such design, implementation and operation. None of the mentioned internal control frameworks (COSO, CoCo, or Turnbull) actually provide any specific requirements or guidance on these matters specifically for internal control over financial reporting – particularly not on effectiveness criteria or management documentation.<sup>2</sup>

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<sup>2</sup> We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW FAIT 1) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

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Second, building on the standards and guidance for internal control over financial reporting, a principles-based standard with additional guidance is needed for management's assessment of internal control over financial reporting. The proposed management guidance allows considerable flexibility, but at the same time certain "stakes in the ground" (requirements) need to be set at a principles-based level if requirements of this sort are included in an auditing standard for auditors.

Finally, a PCAOB standard on the audit of internal control would use the standards and guidance on the design, implementation, operation and assessment of effective internal control over financial reporting by management as a basis for its principles-based requirements and guidance. Since the PCAOB standard would build on the standards for management, quite rightly the PCAOB standard should need less detail and requirements than the standards for management, since most of the requirements and guidance for the audit of internal control would flow from the requirements or guidance that apply to management.

To us, the current and proposed approach of the SEC and PCAOB appears backwards (i.e., the wrong way round). We do not believe that, in the long run, the problems associated with management's assessment of internal control over financial reporting or the auditor's opinion on internal control can be solved without improving the overall structure of pronouncements as noted.

We do welcome, in principle, the move to reduce the costs and burdens associated with management's assessment of internal control over financial reporting and the audit of that internal control by the auditor. However, based upon our reading of the Sarbanes-Oxley Act as noted in section 1 in the Appendix, we do not believe that some of the measures in the proposed management guidance and the proposed PCAOB auditing standard are appropriate. Consequently, we believe that consideration should be given to obtaining legislative changes to the Sarbanes-Oxley Act (hereinafter referred to as the "SOX"). Furthermore, without making the threshold for reasonable assurance and material weaknesses in internal control over financial reporting less stringent, the flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to significant reductions in the work effort of management or the auditors, and hence not lead to the desired cost reduction.



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We would be very pleased to be of further assistance if you have any questions or comments about the contents of our letter.

Yours truly,



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Executive Director



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Appendix

## APPENDIX: Specific Matters

### 1. The elimination of the opinion on management's assessment

In Section II.B.1. of the release, the PCAOB proposes to remove the requirement to evaluate management's process and also the opinion by the auditor on management's assessment. In section II.B.1. of the release, the PCAOB also states that it believes that

"...the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process."

Furthermore, the separate opinion on management's assessment is viewed as redundant.

In our view, it is questionable whether the SEC and the PCAOB can remove the auditor's opinion on management's assessment, and whether the above-quoted "belief" is well-founded. SOX Section 404 (b) states:

"Internal Control Evaluation And Reporting.- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, the assessment made by the management [*italics and underlining added*] of the issuer."

Furthermore, SOX Section 103 (a) (2) states:

"In carrying out paragraph (1), the Board [the PCAOB]–

- (A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall– ...
  - (iii) 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) [*italics and underlining added*], and 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 structure and procedures [*italics and underlining added*]–
      - (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the issuer;

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- (bb) *provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;* [italics and underlining added]

Without claiming to be experts in U.S. Federal Securities law, we have doubts that the opinion on management's assessment can be eliminated: we would like to point out that reading the plain English in the SOX, it appears to us that the SOX Section 404 requires an opinion by the auditor on *management's assessment of internal control* and that SOX Section 103 requires the PCAOB to have its auditing standards also include an *opinion by the auditor on the effectiveness of internal control* as defined in Section 103 (2) (A) (iii) (II) (aa) and (bb). As pointed out in our comment letter dated November 21, 2003 to the draft of AS-2, an opinion on management's assessment of internal control is *not* necessarily the same as an opinion on the effectiveness of internal control.

Some have interpreted the opinion on management's assessment as constituting an opinion on management's assertion with respect to internal control as opposed to an opinion on management's assessment.<sup>3</sup> However, this then begs the question as to why the SOX appears to require an opinion on the assessment and an opinion on internal control, since if an opinion on management's assessment represents an opinion on management's assertion, then no separate opinion on internal control by the auditor would be necessary. For these reasons, we believe that the SOX 404 is directing auditors to provide an opinion on management's assessment, whereas SOX 103 is directing the PCAOB to require in its auditing standards an auditor's opinion on internal control. Since management's assessment would be performed on the basis of the same nature and extent of procedures as the audit of internal control would (with the exception of the audit work on management's assessment), SOX requires a separate opinion on management's assessment *process* because that provides important information about internal control over financial reporting to investors.

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<sup>3</sup> See footnote 20 on page 15 in PCAOB Release 2007-007, PCAOB Rulemaking Docket Matter No. 021 „Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, and Related Other Proposals

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The proposal to eliminate the evaluation of management's assessment is designed primarily to reduce audit costs. To some extent this will be true, however, given that management's assessment process constitutes a part of the internal control over financial reporting from the auditor's point of view, the auditor will not be able to discount the process entirely and so cost savings may not be as great as anticipated.

Consequently, we have doubts that it would be appropriate to eliminate one or the other opinion pursuant to the SOX. It appears to us that the direct opinion by the auditor on internal control has less support in the SOX than the one on management's assessment: consequently, it is the former that is more of a candidate for elimination than the latter.

However, we would like to be clear that, in principle, we welcome the efforts by the SEC and the PCAOB to reduce the cost and burdens associated with implementing the SOX. On this basis, we would regard it to be preferable if the SOX had required a management assertion on internal control on the basis of a management assessment of internal control, and then an audit opinion on that management assertion only (in addition to the opinion on the financial statements, for the financial statements also represent assertions by management), rather than an audit opinion on internal control directly. This solution would emphasize management's responsibility for internal control. Unfortunately, the SOX does not appear to support that route. In our view, the correct solution to this problem can only be achieved by having the U.S. Congress amend the SOX.

## **2. The structure of the pronouncements**

The audit of internal control over financial reporting is predicated upon adequate documentation of internal control by management. However, such documentation of internal control over financial reporting presupposes that there are adequate controls to be documented.

Nevertheless, when examining the proposed management guidance, it only addresses the performance, evidence, and documentation of management's assessment of internal control over financial reporting. An overall impression arising from the proposed management guidance is that management's assessment would almost be an extra task undertaken by management who would otherwise have little to do with internal control (for example the discussion as to the need to establish which controls are to be tested, where more than one control operates with the same control objective). In reality, this cannot be the case, since management has already had to take responsibility for the design and im-

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plementation of the internal control processes and procedures and so it already needs to have satisfied itself that these controls will be sufficient and capable of operating efficiently and effectively. Requirements and guidance with respect to the actual design, implementation and operation of effective internal control are not addressed except by reference to the internal control frameworks COSO, CoCo and Turnbull. An examination of COSO, CoCo and Turnbull reveals that none of these actually appear to contain effectiveness criteria for internal control over financial reporting – nor do they appear contain documentation requirements in relation to internal control over financial reporting.

Furthermore, the language used in the proposed management guidance is often vague. For example, on page 27 “...it is unlikely management will identify only this type of control...as adequately addressing a financial reporting risk...” This could be more precise, stating that “in rare circumstances” or something similar. The use of terms such as “ordinarily” and “generally” weakens the guidance, as management may not feel compelled to follow certain aspects even when it would be appropriate for them to do so.

In our view, what is lacking are principles-based standards, and guidance, for management on the design, implementation, operation (including effectiveness criteria) and documentation of effective internal control over financial reporting.<sup>4</sup> Without such standards and guidance, there is effectively no firm basis for management’s assessment of internal control or the documentation thereof and hence no basis for the audit of either management’s assertion or assessment of internal control over financial reporting, nor for the audit of internal control. In terms of the Assurance Framework as issued by the International Auditing and Assurance Standards Board, what is lacking are “suitable criteria” for internal control over financial reporting and documentation standards to make such internal control assessable or auditable.

To overcome this lack of suitable criteria, both the proposed management guidance and, even more so, the proposed PCAOB auditing standard, contain criteria for the assessment and audit, respectively, of internal control from which the

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<sup>4</sup> We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW Stellungnahme zur Rechnungslegung: Grundsätze ordnungsmäßiger Buchführung bei Einsatz von Informationstechnologie (IDW RS FAIT 1) [“IDW Accounting Principle: Principles of Proper Accounting When Using Information Technology”] (IDW AcP FAIT 1)) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

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needed design, implementation and operation of internal control over financial reporting can be derived. However, this is not the appropriate place for these: it leads to the criteria in the proposed management guidance and the requirements and guidance in the proposed PCAOB auditing standard actually determining how effective internal control over financial reporting ought to be designed, implemented and operated. In other words, the standards and guidance for assessment and audit drive the design, implementation and operation of internal control over financial reporting. Needless to say, this is the wrong way round.

Furthermore, the lack of a principles-based documentation standard and guidance for the design, implementation, operation and assessment by management of internal control over financial reporting effectively leads to the PCAOB Auditing Standard No. 3 “Audit Documentation” (AS-3) becoming the standard for the documentation of management’s design, implementation, operation and assessment of internal control because

- the PCAOB documentation standard is much more stringent than the concomitant documentation requirements for management’s assessment and certainly more stringent than the nonexistent documentation requirements for the design, implementation and operation of internal control over financial reporting (For example, page 38 of the proposed management guidance states “Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company’s books and records should be sufficient to provide reasonable support for its assessment.” However, there is no reference as to the fact this “reasonable support” would need to be sufficient from the point of view of a third-party expert or similar, such as for the auditor. As the assessment that management performs is itself an internal control, documentation needs to be at a similar level as that required of an auditor, such that it is capable of being audited. This guidance contrasts sharply with documentation requirements with which an auditor must comply. AS-3 no. 4 states that “Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached...”; no. 6 states that “Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b. To determine who performed the work and

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the date such work was completed as well as the person who reviewed the work and the date of such review.”)

- PCAOB enforcement activities will drive auditors to comply with the documentation requirements in that standard,
- This will in turn drive auditors to require management to document their assessment and controls in a manner so that they can be audited and documented in accordance with AS-3.

Consequently, an auditing documentation standard will drive management documentation of internal control over financial reporting and their assessment thereof. When auditors are subjected to enforcement activities such as inspections, effectively the adage “not documented – not done” applies. The question arises as to why this does not apply to management in relation to internal control and its assessment.

We would like to point out that one of the main reasons for issuing the proposed management guidance was to avoid the situation where auditing standards drive management activities. It is apparent that due to more stringent requirements and detailed guidance for the audit of internal control, as well as for documenting that audit, than exists in the proposed management guidance, one of the primary objectives for the issuance of management guidance will not be achieved.

Furthermore, it is the existence of adequate documentation of internal control that more than any other measure would contribute to the reduction in audit costs in relation to internal control (e.g., when performing walk-through tests: PCAOB Proposed AS-5 paragraphs 36 et seq. state that “The auditor should perform a walk-through tests for each significant process.... “ and ”These probing questions are essential to the auditor’s ability to gain a sufficient understanding of the process...”). Such documentation would also benefit management for the purposes of its assessment.

### **3. Inherent limitations of internal control**

Although the second Note to A5 in the proposed PCAOB auditing standard does address inherent limitation of internal control (and hence of audits thereof), it does not do so in a systematic manner. By definition, inherent limitations are matters that can only be mitigated to some degree – not eliminated. The proposed PCAOB auditing standard should clarify that there are certain kinds of misstatement risks (and hence ICFR risks) that are not only higher, but to which

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internal control is not as an effective response as for other risks. In other words, some elements of financial statements or issues (e.g., fraud, management override, related party disclosures, significant accounting estimates, critical accounting policies, complex matters or those requiring significant judgment) represent inherent limitations on internal control that affect the effectiveness of internal control and hence the assurance that can be obtained on that effectiveness. This has an impact on the meaning of “reasonable assurance” in relation to the effectiveness of internal control and the audit of internal control, as well as its meaning in relation to the audit of the financial statements.

#### **4. Reasonable assurance and material weaknesses in internal control**

##### *Current problem*

The current description of reasonable assurance in extant AS-2, and hence the definitions of significant and material weaknesses, are dominated by the reference to reasonable assurance being an unmitigated “high” level of assurance and the link to a remote likelihood of misstatement risk. In particular, the description of reasonable assurance in AS-2 paragraph 17 states:

“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.”

This description has been subject to considerable criticism by the IDW, among others, in its previous comment letters to both the PCAOB and the SEC on proposed AS-2 (see IDW comment letters to the PCAOB and SEC on proposed AS-2 dated November 21, 2003 and May 17, 2004, respectively). We refer you to our arguments in these comment letters on the meaning of reasonable assurance.

In particular, our comment letters noted that the implied contention that prudent officials (refer to definition of reasonable assurance in SEC final rule release no. 33-8238 as “...the degree of assurance as would satisfy prudent officials in the conduct of their own affairs”; this concept is also referred to within the proposed management guidance on page 15) are *always* able to use controls to obtain a burden of persuasion equivalent to a “*remote* likelihood of being wrong” and the reference to an unmitigated “high” level of assurance cause concern.

##### *Effect of proposed changes*



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We are pleased that the SEC and the PCAOB have recognized the need to amend the definition of material weakness and significant deficiency and then by implication, the meaning of reasonable assurance. We are particularly pleased with the description of reasonable assurance on page 15 of the proposed management guidance, which refers to the definition given in the Exchange Act Section 13 (b) (7) by means of the “degree of assurance as would satisfy prudent officials in the conduct of their own affairs.” However, this description does not appear to be consistent with the description of reasonable assurance in paragraph 77 in the proposed standard, because this latter description is linked here to the term “significant deficiency” (this latter description also does not appear to be consistent with the definition of “significant deficiency” in paragraph A12 of the proposed standard), whereas the description from paragraph 13 (b) (7) appears to be linked to the term “material weaknesses” in the proposed management guidance.

Page 14 of the proposed management guidance states:

“Management is required to assess as of the end of the fiscal year whether the company’s ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting.”

Furthermore, paragraph A8 in the proposed standard defines the term “material weakness” as follows:

“A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement in the company’s annual or interim financial statements will not be prevented or detected.”

By defining “material weakness” in this way, the proposed PCAOB auditing standard links reasonable assurance that an ICFR is reliable, with the reasonable possibility that a material misstatement will not be prevented or detected by the ICFR. By implication, then, reasonable assurance that the ICFR is reliable would be when there is no reasonable possibility that a material misstatement will not be prevented or detected by the ICFR.

**However, closer examination of these definitions and the use of the term “reasonable possibility” rather than “remote likelihood” shows that the change in terminology has led to no substantive change in meaning.** In particular the note to paragraph A8 in the proposed PCAOB auditing standard states that:

“There is a **reasonable possibility** of an event as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likeli-

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hood of the event is either “reasonably possible” or “probable”, as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (“FAS No. 5”).”

However, the definitions of FAS 5 paragraphs 3b and c state:

“*Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.”

“*Remote*. The chance of the future event or events occurring is slight.”

Hence, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither reasonably possible (more than remote but less than likely) nor probable. In other words, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither more than remote but less than likely, nor probable. This means that reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is remote. This is no real change from the current definitions.

The SEC and the PCAOB should recognize that if a remote likelihood of risk drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is this likelihood that will continue to drive the nature and extent of management’s assessment of internal control over financial reporting and the nature and extent of the audit of internal control by the auditor at two levels: 1. the reasonable assurance required of the internal control system, and the reasonable assurance required for management’s assessment, and 2. the reasonable assurance required for the audit of internal control to determine whether internal control has achieved reasonable assurance of reliability. This definition will also drive the PCAOB enforcement function’s interpretation of what represents a reasonable work effort. For these reasons, despite the flexibility given management in the proposed management guidance to perform management’s assessment, and the reduction in the detailed requirements and guidance in the proposed PCAOB auditing standard, the retention of an effective threshold of a remote likelihood would prevent a significant reduction in the overall work effort for either management or auditors.

Furthermore, if “remote likelihood” drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is hard for us to understand, how in virtually the “same breath”, the proposed management guidance and the proposed PCAOB auditing standard can speak of the inherent limitations of internal control and of audits for such matters as management

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fraud involving collusion, and yet still claim that it is possible for management to reduce the risk of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR, or of the auditor not detecting material weaknesses not detected and corrected by management's assessment, to a remote likelihood of risk. These arguments apply to other instances where reasonable assurance may represent at most what we termed in our previous comment letters to be the "preponderance of the evidence" (e.g., such control and audit issues as the identification of related parties, revenue recognition in complex borderline cases, etc.).

On the other hand, there are many circumstances where internal control can reasonably, and therefore should, reduce the risk of misstatement to a remote likelihood, such as in relation to simple computations of a routine nature in relation to material account balances, or in those exceptional circumstances when accounting evidence, and hence audit evidence, in relation to a particular assertion needs no interpretation and is therefore incontrovertible. As a result, we firmly believe that what "reasonable assurance" is depends upon the circumstances – i.e., the nature of the assertion and related evidence, the resulting related potential risk of misstatement, and hence the nature of the controls or audit procedures that can reasonably be maintained or performed, respectively, to respond to that risk. *In our view, it is not possible to effectively define reasonable assurance (and hence material weaknesses) in terms of certain narrative expressions of Bayesian probability, and we therefore recommend that both the SEC and the PCAOB refrain from doing so.* Such narrative expressions of Bayesian probability could, at most, be used to describe the acceptable range within which the obverse of "reasonable assurance" may occur (i.e., between remote and less than likely, where the actual assurance that is reasonable within that range depends upon the circumstances).

We suggest that the SEC and PCAOB adopt one definition of reasonable assurance that ought to be applied to the definitions of significant deficiency and material weakness (and hence the desired reliability of the ICFR) and express the work effort for both management's assessment and the audit. We believe the most appropriate definition of reasonable assurance to be

"...the degree of assurance as would satisfy prudent officials in the conduct of their own affairs",

as noted above and as effectively referred to on page 15 of the proposed management guidance. Since by its very nature, the level of "reasonable" assurance cannot be a constant; what is reasonable will vary according to the particular circumstances. We have no difficulty with the use of the word "high" in relation

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to assurance as long it is appropriately qualified to convey the varying nature of what “high” means. For this reason, if retention of the word “high” continues to be desired in the proposed PCAOB auditing standard (see item a. in Amendment to AU sec. 230 in Appendix 4 of the proposed standard), we suggest using the phrase “reasonable assurance is a high level of assurance subject to the inherent limitations of internal control”, or “reasonable assurance is a high level of assurance subject to the inherent limitations of an audit”, as appropriate (see discussion of inherent limitations in the Appendix).

By the same token, expressions of risk would also need to recognize their relative – as opposed to constant – nature by equating “reasonable assurance” with “acceptably low level of risk”. For these reasons we propose defining a material weakness in internal control over financial reporting as:

“A control deficiency, or combination of control deficiencies, such that there is a greater than acceptably low level of risk that internal control over financial reporting will not prevent, or detect and correct, a material misstatement in the financial statements on a timely basis”.

## **5. Focus on controls needed to adequately address risk of material misstatements**

The proposed PCAOB auditing standard emphasizes that the audit should focus on the matters most important to internal control (see page 5 of the Release). In particular, the proposed standard directs the auditor’s attention towards the most important controls (see also page 5 of the Release). The proposed standard implements this objective in the note to paragraph 3 by stating that auditor should select for testing only those controls that are important to the auditor’s conclusion about whether the company’s controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company’s financial statements. Furthermore, paragraph 42 of the proposed standard notes that although there may be more than one control that addresses the assessed risk of misstatement for a particular assertion, it is neither necessary to test all controls to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

Although we agree in principle with this approach to focus on the controls needed to adequately address the risk of material misstatement, we would like to point out that there is an inherent contradiction on the way the approach is described.

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It would be economically inefficient (i.e., the costs would exceed the benefits) for management to establish and maintain redundant internal controls that provided more assurance than reasonable assurance. Only where the redundancy is necessary to achieve reasonable assurance would such redundancy be a part of the control objective. To obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, based on the proposed definition of material weakness, management would establish those controls needed so that there is no reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's internal control over financial reporting (see the discussion on reasonable assurance in section 3 of the Appendix). Leaving aside the issue of controls that are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks, controls established to respond to a particular risk of misstatement of a financial statement assertion therefore cannot be redundant by definition and therefore must all be necessary to ensure an adequate response to that misstatement risk, or management would have had no economic justification for establishing them in the first place.

If all of the controls established by management to respond to a risk of misstatement in relation to a particular financial statement assertion are necessary – as opposed to redundant – to determine whether there is reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, then the auditor has no choice but to select those controls for testing, and to test the design and operating effectiveness of all of these controls to determine whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's internal control over financial reporting in relation to that assertion.

The only exception to this would be circumstances where controls are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks for which there are other adequate controls. In these circumstances, management need not assess the redundant controls and may focus on the control or controls that provide the necessary assurance.

## **6. Individual controls vs. the audit opinion on the company's internal control over financial reporting overall**

The note under paragraph 51 in the proposed PCAOB auditing standard states:

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“Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor’s objective is to express an opinion on the company’s internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.”

We agree that the auditor’s objective is to express an opinion on the company’s internal control over financial reporting overall, rather than an opinion on the effectiveness of each individual control. However, this paragraph leaves the impression that an auditor need not obtain sufficient competent audit evidence in relation to internal control over a particular financial statement assertion, which is contradicts paragraph 3 of the proposed standard and the second sentence of B4 in Appendix A1 of the Release.

This begs the question as to the relationship between the evidence obtained for individual controls, internal control over a particular assertion, and internal control over financial reporting as a whole.

To the extent that particular assertions within the financial statements are independent of one another, we believe that an auditor must obtain sufficient competent audit evidence in relation to internal control (although not for the individual controls) responding to an inherent risk relating to a particular assertion. Hence, while the auditor can vary the evidence obtained regarding the effectiveness of individual controls, the auditor cannot vary the sufficiency and competence of the evidence obtained regarding the effectiveness of internal control over a particular assertion.

As a result, when providing an opinion on internal control over financial reporting as a whole, to the extent the assertions and related controls thereover are independent of one another, the level of assurance obtained on internal control over financial reporting as a whole cannot exceed the assurance obtained for the control, over a particular assertion, for which the least assurance was obtained. Hence, an auditor must obtain sufficient competent audit evidence in relation to internal control over each financial statement assertion (even though what may be sufficient and competent in each case may vary).

## **7. Other Matters**

We are concerned that the proposed standard contains a number of problematic statements or contentions. For example:

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- Paragraph 12, first bullet point: The PCAOB appears to believe that, in the absence of documentation evidencing the effective operation of control, the auditor can supplement inquiry and observation (valid evidence only for that point in time) with “other procedures”. What such “other procedures” could be is not discussed; we are unable to visualize what the PCAOB may have had in mind when drafting this. It appears to us to be unrealistic. To be able to perform an audit, an auditor needs to be able to draw upon existing management documentation of significant control processes and procedures, given that an auditor’s objective is to obtain sufficient competent evidence and record findings within the audit documentation as required by PCAOB AS-3 “Audit Documentation”. At the very least, management would have needed to document all of the controls necessary for effective control over financial reporting as part of its assessment. In this vein, paragraph 56 makes no mention of the fact that an auditor may face a scope limitation when the auditor cannot obtain documentation that could reasonably be expected to exist. We refer to our comment letter to the SEC on its proposed management guidance, and in particular, on the need for more stringent documentation requirements for management in relation to the design, operation and assessment of internal control over financial reporting.
- Paragraph 12, second bullet point: We consider it unlikely that company level controls alone can always be sufficiently effective in addressing the risk of material misstatement at an assertion level.
- Paragraph 12, third bullet point: Is it realistic to rely on management controls to prevent management override in smaller entities where very few individuals work closely together, given the potential for collusion?
- Paragraph 12, last bullet point: In our experience there is almost always a need for modification of software, irrespective of an entity’s size and complexity; perhaps the PCAOB should refer to “customizing” instead.
- The second note to paragraph 62 states: “When sampling is appropriate and the population to be tested is large, increasing the population size does not proportionately increase the required sample size.” We would like to point out that this statement only applies to statistically valid sampling techniques.
- B31 appears oversimplified and is likely to be misleading: for example, it does not consider the other factors can change, e.g., environment can change, which may need to cause consideration as to whether unchanged programs remain appropriate.

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**8. Proposed Auditing Standard “Considering and Using the Work of Others in an Audit”**

We are concerned that when an issuer provides personnel to directly assist the auditor in the audit (proposed AS-5 paragraphs 20 –21), that this personnel will lack sufficient objectivity, necessitating certain steps. We are not convinced that it will be possible to address the conflict of interest, that will always apply to a member of staff of the entity subject to audit, in an effective and cost reductive manner. Such a conflict of interest would need to be addressed by increased supervision and testing of that persons work to an extent that it may negate potential cost savings.

There are many other aspects that need full consideration before an auditor can request direct assistance from personnel of the issuer that have not been given any consideration. For example, we question whether it would be appropriate for members of an issuer’s personnel to take part in the “brainstorming” session required by AU sec. 316.14, given what such a session should entail. As a further example, we wonder what measures can an auditor reasonably undertake to ensure that such “borrowed” audit team members adopt the stringent ethical requirements applicable (e.g., confidentiality) to the audit team.

We believe there may be a need for the PCAOB to identify criteria for the auditor when the auditor determines how the work of others will alter the nature, timing, or extent of the auditor's work, as required by paragraph 17. In particular, although the PCAOB believes routine tests, such as walk-through tests, may be performed by others, it would not be appropriate for issuer staff members to ask the “probing questions” required in paragraph 39.



Ms. Nancy M. Morris  
Secretary, Securities and Exchange Commission  
100 F Street, NE, Washington, DC 20549-1090  
USA

By E-mail: [rule-comments@sec.org](mailto:rule-comments@sec.org)

February 26, 2007

Dear Ms. Morris:

**Re.: File Number S7-24-06  
Release Nos. 33-8762; 34-54976  
Management's Report on Internal Control Over Financial Reporting**

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany] (IDW) is pleased to have the opportunity to comment on the above-mentioned releases concerning the Securities and Exchange Commission's proposed interpretative guidance for management regarding its evaluation of internal control over financial reporting and the related proposed rule amendments in the document entitled "Management's Report on Internal Control Over Financial Reporting" (hereinafter referred to as the "proposed management guidance").

The IDW represents the profession of public auditors in Germany and is seeking to comment on the proposed management guidance because a significant number of IDW members audit, or are involved in the audit of, SEC-Registrants or German subsidiaries of such registrants that may be affected by the proposed management guidance, if adopted. Furthermore, these members will be directly affected by the PCAOB's proposed new standard "An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements" (PCAOB Rulemaking Docket No. 21 – hereinafter referred to as the "proposed PCAOB auditing standard"), that represents the PCAOB's auditing counterpart to the SEC's proposed management guidance. Many of our com-

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ments are made in light of the relationship between these two documents and we therefore refer the SEC to our comment letter to the PCAOB on the proposed PCAOB auditing standard, which we have attached for reference.

Our letter contains matters of general concern. Further matters of specific concern and more detailed analyses are addressed in the Appendix to this letter.

## **General Matters**

### **Comment period**

We are pleased to note that the SEC and PCAOB have aligned their periods of exposure for the proposed management guidance and the proposed PCAOB auditing standard. However, we are disappointed to see the short exposure period in which comments can be provided to the SEC and PCAOB, particularly since both bodies published their proposals immediately prior to the Christmas holiday season and many organizations would like to have the opportunity to consult more thoroughly with their stakeholders. Due to the rather short comment period, we have only been able to “scratch the surface” in terms of the issues contained in the proposed management guidance.

### **Overall comments**

We appreciate the initiative taken by both the SEC and the PCAOB to revisit the issue of internal control over financial reporting from both management and auditor perspectives and the effort made to align the two documents. In previous comment letters to the PCAOB and the SEC, we had noted a number of issues in the then proposed PCAOB auditing standard AS-2, and have most recently commented on the SEC’s concept release that we support the issuance of guidance for management. We continue to believe that there is a need for principles-based requirements, and guidance, on management’s design, implementation and operation of internal control over financial reporting, as well as for the performance of management’s assessment of that internal control.

In particular, as a matter of principle (though not necessarily the manner proposed), we welcome the fact that management is allowed a high degree of flexibility in its approach to assessing internal control. The proposed top-down approach will allow management to determine which controls are the most significant for financial reporting purposes. In principle, we also support the

- emphasis that has been placed on assessment of the risk of material misstatement,

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- increased emphasis on professional judgment (rather than check-list mentality),
- necessity of evidential support, and
- the approach to first consider general controls, and then application controls.

However, we have serious concerns about the way in which these matters have been implemented in the guidance – in particular, the disconnect between the proposed management guidance and the proposed PCAOB standard and some of the internal logical inconsistencies within the proposed management guidance.

The impetus to issue management guidance appears to have been twofold: 1. the desire that management's design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard<sup>1</sup>, and 2. the desire to ensure that managements' assessments are carried out efficiently to reduce unnecessary costs and burdens.<sup>2</sup> We believe that, in light of the proposed PCAOB auditing standard, the proposed guidance will not meet the first objective, and that there is a danger that the proposed guidance will not achieve the second objective.

#### *Proposed management guidance vs. PCAOB internal control standard*

The Commission has emphasized "that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures".<sup>3</sup> We agree with this emphasis. However, the proposed management guidance allows management greater flexibility in carrying out its assessment of internal control over financial reporting than the proposed PCAOB auditing standard allows the auditor in auditing that internal control: the requirements and guidance in the proposed PCAOB auditing standard are more precise and stringent, allow less flexibility,

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<sup>1</sup> SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 10.

<sup>2</sup> SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 7.

<sup>3</sup> SEC, Management's Report on Internal Control Over Financial Reporting, File No. S7-24-06, p. 8

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and are in greater detail, than in the proposed management guidance. For example, the management guidance on company-level controls (page 25 et seq.) is far less detailed than that for the auditor (proposed AS-5 paragraphs 17-23). Another example is the fact that walk-through tests are required in the audit of internal control, but not for management's assessment of internal control.

This disconnect between the proposed management guidance and the proposed PCAOB auditing standard will inevitably lead to auditors auditing internal control over financial reporting using the more stringent criteria in the proposed auditing standard, than those applied by management in designing, implementing, operating and assessing that internal control, because PCAOB enforcement activities will drive auditors to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard. Consequently, auditors would be placed into the position of pressuring management to apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard too. If management were to apply the more stringent requirements in the auditing standard, then the first objective for issuing the management guidance (see above – i.e., the desire that management's design, implementation, operation and assessment of internal control not be driven by requirements in an auditing standard) will not be achieved. If management were not to do so on the basis that they are not required to do so by the proposed management guidance, then auditors would apply the more stringent and detailed requirements and guidance in the proposed PCAOB auditing standard to the internal control system when management does not, which would lead to the inference that the auditor is taking greater responsibility for internal control than management is. This also appears to violate the fact emphasized by the SEC that management – not the auditor – is responsible for internal control.

The fact that the proposed management guidance allows management such a high degree of flexibility in performing its management assessment when the proposed PCAOB auditing standard does not for the auditor when auditing internal control also begs the question as to whether "reasonable assurance" for management is the same as "reasonable assurance" for the auditor (see discussion of reasonable assurance below). If they are the same, then the nature and extent of management's assessment ought to be at least the same as the nature and extent of the audit of internal control by the auditor (with of course, the exception of the auditor's procedures on management's assessment). If they are not (i.e, if management obtains less assurance than the auditor), then this again appears to violate the fact that management bears greater responsibility for internal control over financial reporting than the auditor.

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### *Reduction of costs and burdens*

The proposed management guidance together with the proposed PCAOB auditing standard anticipate cost savings, both for the entity directly and indirectly in respect of consulting and audit fees.

We believe that a significant part of the costs of implementing management's assessment and of AS-2 result from the fact that many entities do not possess sufficient documentation of their internal control. Consequently, companies require significant consulting from outside parties on the basis of AS-2 to document controls so that they are in a position to perform management's assessment of internal control, and so that auditors can audit internal control. Furthermore, auditors provide considerable advice on what would constitute effective internal control over financial reporting for the purposes of the audit based upon the detailed requirements and guidance in AS-2. Only when management has designed, implemented and is operating well-documented internal controls and has performed a well-documented assessment of those controls can audit costs be reduced. Nevertheless, the cost of documenting, and obtaining consulting on, internal control changes, management's assessment, and the audit of internal control will remain greater than anticipated by the proposed management guidance and the proposed PCAOB auditing standard because, as a whole, no effective reduction in the stringency of the requirements for management's assessment or the audit of internal control has taken place (see the discussion on "reasonable assurance" below.)

In particular, the suggested removal of the need for auditors to provide an opinion on management's assessment is supposed to reduce unnecessary duplication of work. However, given that management's assessment process constitutes an internal control over financial reporting from the auditor's point of view, auditors would have based part of their audit work on examining that assessment in any case. Consequently, the elimination of an opinion on management's process will not lead to cost savings that are as great as anticipated.

### **Reasonable assurance and material weaknesses in internal control**

We refer to section 3 in the Appendix for a brief outline of the problems with the current definitions of "reasonable assurance" and "material weakness in internal control" in AS-2, for a detailed examination of the actual meaning of the change in definition included in the proposed PCAOB auditing standard (and the proposed management guidance also), and for an analysis of the implications. **This**

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**analysis shows that no effective change has taken place in the meaning of either “reasonable assurance” or “material weakness in internal control”:** The proposed definition means that reasonable assurance that the ICFR is reliable is achieved when the likelihood that a material misstatement will not be prevented or detected by the ICFR is *remote*.

We would like to point out that the effective use of a *remote* likelihood of risk as a threshold for reasonable assurance (for the reliability of internal control, for management’s assessment, and for the audit of internal control) will drive the nature and extent of the design and operation of internal control, management’s assessment of internal control and the audit of internal control. The flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to any significant reduction in the work effort of management or the auditor (and any significant reduction in costs) as long as this threshold drives their work.

We recommend that the SEC and the PCAOB adopt one definition of reasonable assurance that also forms the basis for the definition of material weakness as noted in section 3 in the Appendix.

### Concluding Comments

In our view, based on the comments above and in section 2 in the Appendix, the approach taken by the SEC and the PCAOB ought to have been reversed from what has taken, and is taking, place. In other words, what is needed, first and foremost, are principles-based standards, and guidance, for management on the **design, implementation, and operation** of effective internal control over financial reporting, including **suitable effectiveness criteria** for, and the **documentation** of, such design, implementation and operation. None of the mentioned internal control frameworks (COSO, CoCo, or Turnbull) actually provide any specific requirements or guidance on these matters specifically for internal control over financial reporting – particularly not on effectiveness criteria or management documentation.<sup>4</sup>

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<sup>4</sup> We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW FAIT 1) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

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Second, building on the standards and guidance for internal control over financial reporting, a principles-based standard with additional guidance is needed for management's assessment of internal control over financial reporting. The proposed management guidance allows considerable flexibility, but at the same time certain "stakes in the ground" (requirements) need to be set at a principles-based level if requirements of this sort are included in an auditing standard for auditors.

Finally, a PCAOB standard on the audit of internal control would use the standards and guidance on the design, implementation, operation and assessment of effective internal control over financial reporting by management as a basis for its principles-based requirements and guidance. Since the PCAOB standard would build on the standards for management, quite rightly the PCAOB standard should need less detail and requirements than the standards for management, since most of the requirements and guidance for the audit of internal control would flow from the requirements or guidance that apply to management.

To us, the current and proposed approach of the SEC and PCAOB appears backwards (i.e., the wrong way round). We do not believe that, in the long run, the problems associated with management's assessment of internal control over financial reporting or the auditor's opinion on internal control can be solved without improving the overall structure of pronouncements as noted.

We do welcome, in principle, the move to reduce the costs and burdens associated with management's assessment of internal control over financial reporting and the audit of that internal control by the auditor. However, based upon our reading of the Sarbanes-Oxley Act as noted in section 1 in the Appendix, we do not believe that some of the measures in the proposed management guidance and the proposed PCAOB auditing standard are appropriate. Consequently, we believe that consideration should be given to obtaining legislative changes to the Sarbanes-Oxley Act (hereinafter referred to as the "SOX").

Furthermore, without making the threshold for reasonable assurance and material weaknesses in internal control over financial reporting less stringent, the flexibility given management in the proposed management guidance and the reduction in detailed requirements in the proposed PCAOB auditing standard will not lead to significant reductions in the work effort of management or the auditors, and hence not lead to the desired cost reduction.

We would be very pleased to be of further assistance if you have any questions or comments about the contents of our letter.

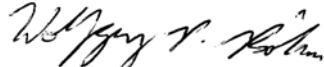
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Yours truly,



Klaus-Peter Feld

Executive Director



Wolfgang P. Böhm

Director, International Affairs

494/538

Appendix



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## APPENDIX: Specific Matters

### 1. The elimination of the opinion on management's assessment

Page 52 of the proposed management guidance states :

“Our rules implementing Section 404(b) of Sarbanes-Oxley require every registered public accounting firm that issues or prepares an audit report on a company's financial statements for inclusion in an annual report that contains an assessment by management of the effectiveness of the registrant's ICFR to attest to, and report on, such assessment. Pursuant to Rule 2-02(f), the accountant's attestation report must clearly state the “opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's ICFR is fairly stated in all material respects.” Over the past three years we have received feedback that the current form of the auditor's opinion may not effectively communicate the auditor's responsibility in relation to management's evaluation process. Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. In addition, we are proposing revisions to Rule 2-02(f) to clarify the circumstances in which we would expect that the accountant cannot express an opinion.

We are also proposing conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. We believe this opinion necessarily conveys whether management's assessment is fairly stated.”

In our view, it is questionable whether the SEC and the PCAOB can remove the auditor's opinion on management's assessment, and whether the above-quoted “belief” is well-founded. SOX Section 404 (b) states:

“Internal Control Evaluation And Reporting.- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues an audit report for the issuer shall attest to, and report on, the assessment made by the management [*italics and underlining added*] of the issuer.”

Furthermore, SOX Section 103 (a) (2) states:

“In carrying out paragraph (1), the Board [the PCAOB]–

- (A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall– ...

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- (iii) 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) [*italics and underlining added*], and 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 structure and procedures [*italics and underlining added*]–
    - (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the issuer;
    - (bb) provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; [*italics and underlining added*]

Without claiming to be experts in U.S. Federal Securities law, we have doubts that the opinion on management's assessment can be eliminated: we would like to point out that reading the plain English in the SOX, it appears that the SOX Section 404 requires an opinion by the auditor on *management's assessment of internal control* and that SOX Section 103 requires the PCAOB to have its auditing standards also include an *opinion by the auditor on the effectiveness of internal control* as defined in Section 103 (2) (A) (iii) (II) (aa) and (bb). As pointed out in our comment letter dated November 21, 2003 to the draft of AS-2, an opinion on management's assessment of internal control is *not* necessarily the same as an opinion on the effectiveness of internal control.

Some have interpreted the opinion on management's assessment as constituting an opinion on management's assertion with respect to internal control as opposed to an opinion on management's assessment.<sup>5</sup> However, this then begs the question as to why the SOX appears to require an opinion on the assess-

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<sup>5</sup> See footnote 20 on page 15 in PCAOB Release 2007-007, PCAOB Rulemaking Docket Matter No. 021 „Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, and Related Other Proposals

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ment and an opinion on internal control, since if an opinion on management's assessment represents an opinion on management's assertion, then no separate opinion on internal control by the auditor would be necessary. For these reasons, we believe that the SOX 404 is directing auditors to provide an opinion on management's assessment, whereas SOX 103 is directing the PCAOB to require in its auditing standards an auditor's opinion on internal control. Since management's assessment would be performed on the basis of the same nature and extent of procedures as the audit of internal control would (with the exception of the audit work on management's assessment), SOX requires a separate opinion on management's assessment *process* because that provides important information about internal control over financial reporting to investors.

Consequently, we have doubts that it would be appropriate to eliminate one or the other opinion pursuant to the SOX. It appears to us the direct opinion by the auditor on internal control has less support in the SOX than the one on management's assessment: consequently, it is the former that is more of a candidate for elimination than the latter.

However, we would like to be clear that, in principle, we welcome the efforts by the SEC and the PCAOB to reduce the cost and burdens associated with implementing the SOX. On this basis, we would regard it to be preferable if the SOX had required a management assertion on internal control on the basis of a management assessment of internal control, and then an audit opinion on that management assertion only (in addition to the opinion on the financial statements, for the financial statements also represent assertions by management), rather than an audit opinion on internal control directly. This solution would emphasize management's responsibility for internal control. Unfortunately, the SOX does not appear to support that route. In our view, the correct solution to this problem can only be achieved by having the U.S. Congress amend the SOX.

## **2. The structure of the pronouncements**

The performance of management's assessment of internal control over financial reporting is predicated upon adequate documentation of internal control so that such an assessment can be carried out. Likewise, the audit of internal control over financial reporting is predicated upon adequate documentation of internal control by management. However, such documentation of internal control over financial reporting presupposes that there are adequate controls to be documented.

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Nevertheless, when examining the proposed management guidance, it only addresses the performance, evidence, and documentation of management's assessment of internal control over financial reporting. An overall impression arising from the proposed management guidance is that management's assessment would almost be an extra task undertaken by management who would otherwise have little to do with internal control (for example the discussion as to the need to establish which controls are to be tested, where more than one control operates with the same control objective). In reality, this cannot be the case, since management has already had to take responsibility for the design and implementation of the internal control processes and procedures and so it already needs to have satisfied itself that these controls will be sufficient and capable of operating efficiently and effectively. Requirements and guidance with respect to the actual design, operation and maintenance of effective internal control are not addressed except by reference to the internal control frameworks COSO, CoCo and Turnbull. An examination of COSO, CoCo and Turnbull reveals that none of these actually appear to contain effectiveness criteria for internal control over financial reporting – nor do they appear contain documentation requirements in relation to internal control over financial reporting.

Furthermore, the language used in the proposed management guidance is often vague. For example, on page 27 "...it is unlikely management will identify only this type of control....as adequately addressing a financial reporting risk..." This could be more precise, stating that "in rare circumstances" or something similar. The use of terms such as "ordinarily" and "generally" weakens the guidance, as management may not feel compelled to follow certain aspects even when it would be appropriate for them to do so.

In our view, what is lacking are principles-based standards and guidance for management on the design, implementation, operation (including effectiveness criteria) and documentation of effective internal control over financial reporting.<sup>6</sup> Without such standards and guidance, there is effectively no firm basis for management's assessment of internal control or the documentation thereof and

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<sup>6</sup> We would like to point out that in Germany, the IDW has an accounting pronouncement (IDW Stellungnahme zur Rechnungslegung: Grundsätze ordnungsmäßiger Buchführung bei Einsatz von Informationstechnologie (IDW RS FAIT 1) ["IDW Accounting Principle: Principles of Proper Accounting When Using Information Technology"] (IDW AcP FAIT 1)) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

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hence no basis for the audit of either management's assertion or assessment of internal control over financial reporting, nor for the audit of internal control. In terms of the Assurance Framework as issued by the International Auditing and Assurance Standards Board, what is lacking are "suitable criteria" for internal control over financial reporting and documentation standards to make such internal control assessable or auditable.

To overcome this lack of suitable criteria, both the proposed management guidance and, even more so, the proposed PCAOB auditing standard, contain criteria for the assessment and audit, respectively, of internal control from which the needed design, implementation and operation of internal control over financial reporting can be derived. However, this is not the appropriate place for these: it leads to the criteria in the proposed management guidance and the requirements and guidance in the proposed PCAOB auditing standard actually determining how effective internal control over financial reporting ought to be designed, implemented and operated. In other words, the standards and guidance for assessment and audit drive the design, implementation and operation of internal control over financial reporting. Needless to say, this is the wrong way round.

Furthermore, the lack of a principles-based documentation standard and guidance for the design, implementation, operation and assessment by management of internal control over financial reporting effectively leads to the PCAOB Auditing Standard No. 3 "Audit Documentation" (AS-3) becoming the standard for the documentation of management's design, implementation, maintenance and assessment of internal control because

- the PCAOB documentation standard is much more stringent than the concomitant documentation requirements for management's assessment and certainly more stringent than the nonexistent documentation requirements for the design, implementation and operation of internal control over financial reporting (For example, page 38 of the proposed management guidance states "Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment." However, there is no reference as to the fact this "reasonable support" would need to be sufficient from the point of view of a third-party expert or similar, such as for the auditor. As the assessment that management performs is itself an internal control, documentation needs to be at a similar level as that required of an auditor, such that it is capable of be-

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ing audited. This guidance contrasts sharply with documentation requirements with which an auditor must comply. AS-3 no. 4 states that “Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached...”; no. 6 states that “Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.)

- PCAOB enforcement activities will drive auditors to comply with the documentation requirements in that standard,
- This will in turn drive auditors to require management to document their assessment and controls in a manner so that they can be audited and documented in accordance with AS-3.

Consequently, an auditing documentation standard will drive management documentation of internal control over financial reporting and their assessment thereof. When auditors are subjected to enforcement activities such as inspections, effectively the adage “not documented – not done” applies. The question arises as to why this does not apply to management in relation to internal control and its assessment.

We would like to point out that one of the main reasons for issuing the proposed management guidance was to avoid the situation where auditing standards drive management activities. It is apparent that due to more stringent requirements and detailed guidance for the audit of internal control, as well as for documenting that audit, than exists in the proposed management guidance, one of the primary objectives for the issuance of management guidance will not be achieved.

Furthermore, it is the existence of adequate documentation of internal control that more than any other measure would contribute to the reduction in audit costs in relation to internal control (e.g., when performing walk-through tests: PCAOB Proposed AS-5 paragraphs 36 et seq. state that “The auditor should perform a walk-through tests for each significant process.... “ and ”These probing questions are essential to the auditor’s ability to gain a sufficient understanding of the process...”). Such documentation would also benefit management for the purposes of its assessment.

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### 3. Reasonable assurance and material weaknesses in internal control

#### *Current problem*

The current description of reasonable assurance in extant AS-2, and hence the definitions of significant and material weaknesses, are dominated by the reference to reasonable assurance being an unmitigated “high” level of assurance and the link to a remote likelihood of misstatement risk. In particular, the description of reasonable assurance in AS-2 paragraph 17 states:

“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.”

This description has been subject to considerable criticism by the IDW, among others, in its previous comment letters to both the PCAOB and the SEC on proposed AS-2 (see IDW comment letters to the PCAOB and SEC on proposed AS-2 dated November 21, 2003 and May 17, 2004, respectively). We refer you to our arguments in these comment letters on the meaning of reasonable assurance.

In particular, our comment letters noted that the implied contention that prudent officials (refer to definition of reasonable assurance in SEC final rule release no. 33-8238 as “...the degree of assurance as would satisfy prudent officials in the conduct of their own affairs”; this concept is also referred to within the proposed management guidance on page 15) are *always* able to use controls to obtain a burden of persuasion equivalent to a “remote likelihood of being wrong” and the reference to an unmitigated “high” level of assurance cause concern.

#### *Effect of proposed changes*

We are pleased that the SEC and the PCAOB have recognized the need to amend the definition of material weakness and significant deficiency and then by implication, the meaning of reasonable assurance. We are particularly pleased with the description of reasonable assurance on page 15 of the proposed management guidance, which refers to the definition given in the Exchange Act Section 13 (b) (7) by means of the “degree of assurance as would satisfy prudent officials in the conduct of their own affairs.” Unfortunately, on the one hand, page 14 of the proposed management guidance states “management is required to assess as of the end of the fiscal year whether the company’s

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ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting;” on the other hand, page 13 of the guidance states

“A material weakness is a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement in the company’s annual or interim financial statements will not be prevented or detected on a timely basis by the company’s ICFR”

Either the proposed management guidance has two incompatible definitions of reasonable assurance, or by defining “material weakness” in this way, the proposed management guidance links reasonable assurance that an ICFR is reliable, with the reasonable possibility that a material misstatement will not be prevented or detected by the ICFR. By implication, then, reasonable assurance that the ICFR is reliable would be when there is no reasonable possibility that a material misstatement will not be prevented or detected by the ICFR. Pages 24, and 41 to 42 – including footnote 74 – of the proposed management guidance provide further discussion of these issues.

**However, closer examination of these definitions and the use of the term “reasonable possibility” rather than “remote likelihood” shows that the change in terminology has led to no substantive change in meaning.** In particular footnote 32 in the proposed management guidance states that:

“There is a reasonable possibility of an event when the likelihood of the event is either “reasonably possible” or “probable” as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.”

However, the definitions of FAS 5 paragraphs 3b and c state:

“*Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.”

“*Remote.* The chance of the future event or events occurring is slight.”

Hence, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither reasonably possible (more than remote but less than likely) nor probable. In other words, reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is neither more than remote but less than likely, nor probable. This means that reasonable assurance that the ICFR is reliable would be when the likelihood that a material misstatement will not be prevented or detected by the ICFR is remote. This is no real change from the current definitions.



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The SEC and the PCAOB should recognize that if a remote likelihood of risk drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is this likelihood that will continue to drive the nature and extent of management's assessment of internal control over financial reporting and the nature and extent of the audit of internal control by the auditor at two levels: the reasonable assurance required of the internal control system, and the reasonable assurance required for management's assessment and for the audit of internal control to determine whether internal control has achieved reasonable assurance of reliability. This definition will also drive the PCAOB enforcement function's interpretation of what represents a reasonable work effort. For these reasons, despite the flexibility given management in the proposed management guidance to perform management's assessment, and the reduction in the detailed requirements and guidance in the proposed PCAOB auditing standard, the retention of an effective threshold of a remote likelihood would prevent a significant reduction in the overall work effort for either management or auditors.

Furthermore, if "remote likelihood" drives the definition of reasonable assurance and hence of significant deficiencies or material weaknesses, it is hard for us to understand, how in virtually the "same breath", the proposed management guidance and the proposed PCAOB auditing standard can speak of the inherent limitations of internal control and of audits for such matters as management fraud involving collusion, and yet still claim that it is possible for management or auditors to reduce the risk of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR, or of the auditor not detecting material weaknesses not detected and corrected by management's assessment, to a remote likelihood of risk. These arguments apply to other instances where reasonable assurance may represent at most what we termed in our previous comment letters to be the "preponderance of the evidence" (e.g., such control and audit issues as the identification of related parties, revenue recognition in complex borderline cases, etc.).

On the other hand, there are many circumstances where internal control can reasonably, and therefore should, reduce the risk of misstatement to a remote likelihood, such as in relation to simple computations of a routine nature in relation to material account balances, or in those exceptional circumstances when accounting evidence, and hence audit evidence, in relation to a particular assertion needs no interpretation and is therefore incontrovertible. As a result, we firmly believe that what "reasonable assurance" is depends upon the circumstances – i.e. the nature of the assertion and related evidence, the resulting related potential risk of misstatement, and hence the nature of the controls or au-

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dit procedures that can reasonably be maintained or performed, respectively, to respond to that risk. *In our view, it is not possible to effectively define reasonable assurance (and hence material weaknesses) in terms of certain narrative expressions of Bayesian probability, and we therefore recommend that both the SEC and the PCAOB refrain from doing so.* Such narrative expressions of Bayesian probability could, at most, be used to describe the acceptable range within which the obverse of “reasonable assurance” may occur (i.e., between remote and less than likely, where the actual assurance that is reasonable within that range depends upon the circumstances).

We suggest that the SEC and PCAOB adopt one definition of reasonable assurance that ought to be applied to the definitions of significant deficiency and material weakness and express the work effort for both management’s assessment and the audit. We believe the most appropriate definition of reasonable assurance to be

“...the degree of assurance as would satisfy prudent officials in the conduct of their own affairs”,

as noted above and as effectively referred to on page 15 of the proposed management guidance. Since by its very nature, the level of “reasonable” assurance cannot be a constant; what is reasonable will vary according to the particular circumstances. We have no difficulty with the use of the word “high” in relation to assurance as long it is appropriately qualified to convey the varying nature of what “high” means. For this reason, if retention of the word “high” continues to be desired in the proposed PCAOB auditing standard (which would mean retention in the proposed management guidance), we suggest using the phrase “reasonable assurance is a high level of assurance subject to the inherent limitations of internal control”, or “reasonable assurance is a high level of assurance subject to the inherent limitations of an audit” (see discussion of inherent limitations in the Appendix).

By the same token, expressions of risk would also need to recognize their relative – as opposed to constant – nature by equating “reasonable assurance” with “acceptably low level of risk”. For these reasons we propose defining a material weakness in internal control over financial reporting as:

“A control deficiency, or combination of control deficiencies, such that there is a greater than acceptably low level of risk that internal control over financial reporting will not prevent, or detect and correct, a material misstatement in the financial statements on a timely basis”.

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#### 4. Evidence to support the assessment

On page 28 the proposed management guidance states that “as part of its evaluation of ICFR, management must maintain reasonable support for its assessment”. Pages 30 to 34 of the guidance provide further discussion of the evidence needed to support the assessment, including issues of quality, quantity; on page 38 the guidance also states: “Management’s assessment must be supported by evidential matter that provides reasonable support for its assessment.” This page then goes not to describe the nature of the evidential matter.

If one accepts the proposition that management, rather than the auditor, is responsible for internal control, and that therefore management’s assessment must have the same nature and extent as the audit of internal control to obtain the same “reasonable assurance” about its operating effectiveness, then the evidence required to support management’s assessment must be at least as sufficient and competent as that obtained by the auditor to support the auditor’s opinion on internal control. Paragraph 3 of the proposed PCAOB auditing standards does make the connection between “reasonable assurance” and “sufficient competent evidence”. The proposed management guidance does not: page 14 of the proposed management guidance only refers to the assessment of whether the ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting, not whether management’s assessment must obtain reasonable assurance whether this is in fact the case. We suggest that this connection also be made in the proposed management guidance so that more clarity exists about the needed management work effort

#### 5. The lack of requirements and guidance on materiality for management

When the proposed management guidance addresses the “risks” or “financial reporting risks” that management considers in its assessment, it needs to be clear throughout that the “risk of material misstatement” is meant. The phrase “risk of material misstatement “ is meaningless without a discussion, first as to what constitutes a *misstatement* and secondly, and more importantly, what is *material*. We would like to point out that the proposed management guidance provides neither standards nor guidance for either, whereas AU §312 contains a considerable number of requirements and considerable guidance for what is often called “planning materiality” (as opposed to the final materiality level that is applied in evaluating misstatements) that auditors apply in planning the audit, performing risk assessments, and designing audit procedures to respond to risk.

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In fact, while there are some SEC pronouncements that apply to management that deal with the final materiality level used for evaluation of misstatements in the financial statements, there are none that deal with the considerations covered in AU § 312 (in relation to so-called “planning materiality”) for management’s assessment over financial reporting, and in particular for identifying financial reporting risks and identifying controls that adequately address financial reporting risks and performing assessment procedures to determine whether the risk assessment involving expectations of about operating effectiveness is appropriate. Nevertheless, paragraph 14 of the proposed PCAOB auditing standard requires that auditor apply these considerations when auditing internal control. Consequently, these considerations ought to apply equally to management when planning and performing its assessment of internal control.

Given our comments above that there ought to be principles-based standards and guidance for the design, implementation and operation of effective internal control over financial reporting, and the documentation thereof, we believe that in fact management requires principles-based requirements and guidance on the meaning of materiality such as in AU § 312 in order to be able to design, implement and operate effective internal control and document these. Without such requirements and guidance on “planning materiality”, management would not be in position to design effective internal control.

Furthermore, when designing internal controls, management may accept that it is not necessary for a particular control to prevent, or detect and correct all misstatements, i.e., immaterial misstatements. Hence, for efficiency reasons, management may therefore establish that an internal control need not be effective for immaterial misstatements. However, due to the fact that individually immaterial misstatements may aggregate into a material misstatement, guidance is needed for management on setting such a threshold (often termed “tolerable error” in auditing literature or standards) significantly below materiality given management’s misstatement rate expectations.

Likewise, when planning its assessment of internal control and performing its risk assessment for the assessment of internal control, and assessing the operating effectiveness of internal control, management would need to recognize its evaluation process needs to leave a margin for possible undetected weaknesses in internal control. For this reason, guidance is also needed on the application of a threshold lower than materiality when performing the assessment of internal control.

We note the proposed PCAOB auditing standard continues to apply the concept of a “significant deficiency”, which is based upon the concept of a “significant

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misstatement". We have not explored the impact of the concept of a "significant misstatement" on the issues above, but would request that the SEC and the PCAOB address this impact in the proposed management guidance and proposed PCAOB auditing standard, respectively.

## **6. Inherent limitations of internal control**

Page 4 of the proposed management guidance briefly addresses the inherent limitations of internal control with respect to fraud and notes that such fraud risks can be reduced, but not eliminated by means of internal control. Furthermore, page 34 of that guidance points out that certain financial reporting elements (significant accounting estimates, related party transactions, critical accounting policies) or those elements involving management override of internal control, significant judgment or complexity should generally be assessed as having higher ICFR risk.

However, the proposed management guidance does not address the inherent limitations of internal control generally, such as in the second Note to A5 in the proposed PCAOB auditing standard. By definition, inherent limitations are matters that can only be mitigated to some degree – not eliminated. The proposed management guidance should clarify that there are certain kinds of misstatement risks (and hence ICFR risks) that are not only higher, but to which internal control is not as an effective response as for other risks. In other words, these elements or issues as noted above (e.g., fraud, management override, related party disclosures, significant accounting estimates, critical accounting policies, complex matters or those requiring significant judgment) represent inherent limitations on internal control that affect the effectiveness of internal control and hence the assurance that can be obtained on that effectiveness. This has an impact on the meaning of "reasonable assurance" in relation to management's assessment and the audit of internal control, as well as its meaning in relation to the audit of the financial statements.

## **7. Focus on controls needed to adequately address risk of material misstatements**

Page 16 of the proposed management guidance notes that "The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in the financial statements" and ".. if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-

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level control, no further evaluation of other controls is required.” This issue is addressed again on pages 25 and 29 of the proposed management guidance. Additional discussion on page 25 then points out that where redundant controls exist, “management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently”. Although we agree in principle with the approach to concentrate on significant controls and on those for which the evidence can be obtained most efficiently, we would like to point out that there is an inherent contradiction on the way the approach is described in the proposed management guidance.

It would be economically inefficient (i.e., the costs would exceed the benefits) for management to establish and maintain redundant internal controls that provided more assurance than reasonable assurance. Only where the redundancy is necessary to achieve reasonable assurance would such redundancy be a part of the control objective. To obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, based on the proposed definition of material weakness, management would establish those controls needed so that there is no reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company’s internal control over financial reporting (see the discussion on reasonable assurance in section 3 of the Appendix). Leaving aside the issue of controls that are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks, controls established to respond to one particular financial reporting risk (i.e., a particular risk of misstatement of a financial statement assertion) therefore cannot be redundant by definition and therefore must all be necessary to ensure an adequate response to that misstatement risk, or management would have had no economic justification for establishing them in the first place.

If all of the controls established by management to respond to a risk of misstatement in relation to a particular financial statement assertion are necessary – as opposed to redundant – to obtain reasonable assurance that internal control will prevent, or detect and correct material misstatements in relation to a particular financial statement assertion, then management has no choice but to choose to assess the operating effectiveness of all of these controls to determine whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company’s ICFR in relation to that assertion (the same would apply to the auditor’s tests of control).

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The only exception to this would be circumstances where controls are established to respond to a particular business or financial reporting risk but that *en passant* also respond to other financial reporting risks for which there are other adequate controls. In these circumstances, management need not assess the redundant controls and may focus on the control or controls that provide the necessary assurance.

## **8. Consideration of general vs. application controls**

The consideration of general and application controls on page 27 needs to be clarified that only if general controls prevent or detect material misstatement at the assertion level on their own with reasonable assurance can the management determine it is appropriate to disregard further detailed (application) controls. Furthermore, it is increasingly common for general controls to be embedded in IT systems. The guidance uses an increasingly artificial separation which does not adequately reflect current developments in internal control systems.

## **9. Materiality, Risk and Misstatement Risk**

The sentences, on page 33 of the proposed management guidance, describing the relationship between materiality, risk, misstatement risk need slight revision to make them conceptually sounder. In particular, the second and third sentences ought to read:

“For a given chance of misstatement, as the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management’s assessment of risk of misstatement would increase. Likewise, for a given materiality of a financial reporting element, as the chance of misstatement increases, the management’s assessment of the risk of misstatement also increases.”

## **10. Reporting guidance**

The reporting guidance on page 46 states:

“Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that material weaknesses exist, companies should also consider including the following in their disclosures:

- the nature of any material weakness,

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- it impact on financial reporting and control environment, and
- management's current plans, if any, for remediating the weakness."

However, management may not actually provide this disclosure, or provide it improperly. The proposal in the proposed management guidance and the proposed PCAOB auditing standard to no longer require the auditor to opine upon management's assessment, but yet have the auditor evaluate whether management's presentation is complete and fairly presented (see the proposed PCAOB auditing standard paragraph 81 et seq. in combination with C2) without *requiring* such management disclosure or that management's presentation to be complete and fairly presented, appears to be counterproductive because it leaves the impression that the detection and response to material weaknesses is an auditor, rather than a management responsibility. We therefore recommend that the management disclosure noted above be made mandatory.

## **11. Outsourcing**

The treatment of outsourcing on page 48 of the guidance needs to be expanded considerably. For example, there is no discussion of the overlap between the internal control at the service organization and the user entity, nor is there a discussion of the importance of general controls the service organization and whether they may have been subject to audit etc. These are significant issues which the guidance may need to address.