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

Subject: Rulemaking Docket Nr. 008 Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Members and Staff of the Public Company Accounting Oversight Board:

Thank you for the opportunity to comment on the proposed auditing standard on an audit of internal control over financial reporting performed in conjunction with an audit of financial statements. I have had exposure to external audit, internal audit and preparing financial statements as a finance director before returning to academic life to pursue a PhD on internal control over financial reporting. As a result, I hope that my comments reflect a balanced view, which is based on insights from professional experience and research. I appreciate the amount of work that has been invested into the Proposed Auditing Standard by the PCAOB.

Overall, I support the proposed standard. However, I believe that the sections covering using the work of others are too restrictive and may lead to a duplication of work between internal auditors and external auditor. In addition, there is no statutory authority or legal intent as a basis for requiring the auditor to perform limited quarterly procedures concerning changes in internal control over financial reporting and section 302 of the Sarbanes-Oxley Act. Furthermore, some clarifications would be beneficial to avoid misunderstandings in the interpretation of the standard by issuers and auditors.

Please find enclosed my comments on the duplication of work performed by management and others, my answers to the Board's 31 questions, and my comments on individual sections of the proposed standard.

I would be pleased to discuss my comments with the Board or its staff at your convenience.

Yours sincerely,

Georg Merkl

Comments on the Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

1. Duplication of work performed by internal auditors and others

Role of and impact on management

As a result of the Sarbanes-Oxley Act, the SEC requires *management* to evaluate the effectiveness of internal control over financial reporting.[1] For most issuers this is a new task that results in a considerable additional effort because they used to delegate this task to their independent accountant. The main reason was that companies thought that the external auditor covered *most* of internal control over financial reporting during his audit of the financial statements and reported on it in his management letter. This personal experience is supported by a survey of the Institute of Internal Auditors.[2] According to this survey over 66,7% of the companies' internal audit departments will increase audits in financial reporting in 2003. In addition, 44,4% of the companies will increase their audit staff in 2003.

In addition, there is a recent trend to increase the independence of internal auditors by having them functionally report to the audit committee. According to two surveys by the Institute of Internal Auditors, the percentage of Chief Audit Executives reporting to the audit committee increased from 55% in 2002[3] to 74% in 2003[4].

Role of and impact on the independent accountant

The registered public accounting firm shall attest to, and report on, the assessment made by the management of the issuer.[5] Management cannot delegate its responsibility to assess its internal controls over financial reporting to the independent accountant.[6] This wording by congress and the SEC already implies that the independent accountant evaluates and uses the work of management and others.

Overlap and potential duplication of work

As a result, we have a situation where one type of professional independent auditors, the internal auditors, have to audit internal control over financial reporting, and another type of professional independent auditors, the external auditors, have to audit the same area. In other words, we have a new significant overlap of the work of internal auditors and external auditors that did not exist in this magnitude before the

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[1] 17 CFR 240.13a-15(c) and 17 CFR 240.15d-15(c)
[2] The Institute of Internal Auditors, Impact of Sarbanes-Oxley on Interal Audit, February 25, 2003, http://www.gain2.org/soasum.htm, question B1a and question B4
[3] The Institute of Internal Auditors, CAE Reporting Relationships, June 4, 2002, http://www.gain2.org/caereportsum.htm and http://www.gain2.org/finalcaereporting.pdf
[4] The Institute of Internal Auditors, Reporting Lines and Scope of Work, July 6, 2003, http://www.gain2.org/caereporting.ppt and http://www.gain2.org/scopesum.htm
[5] Section 404 (b) of the Sarbanes-Oxley Act of 2002.
[6] Securities and Exchange Commission, Final Rule 33-8238: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Title II., Chapter B., Section 3., Subsection b.

Sarbanes-Oxley Act. The sections of the proposed audit standard, which concern the use of the work of management, and others (sections 103-110) appear to be a change from the flexible risk based approach in SAS No. 65 which has been successfully practised since 1991. In my opinion, the new fixed categories of controls where the auditor should not use the results of testing performed by management and others or where the auditor's use should be limited are not consistent with a risk based and cost efficient audit approach. In addition, I believe the principle that the auditor's own testing must provide the principle evidence for the auditor's opinion is too inflexible. As a consequence, my main concern is that this new fixed approach will result in a duplication of material amounts of work performed by management and internal auditors. Due to the magnitude of the overlap, I urge the Board to examine this issue seriously. I fully agree that the testing performed by management and others should not be taken at face value. However, I believe that a risk assessment as in SAS No. 65 of the work performed by management and internal auditors is a better and more flexible approach to determine the extent of the use of work of management and others. I will elaborate those points in my comments to questions 12-16.

2. Answers to the Board’s 31 questions

Q 1.: Is it appropriate to refer to the auditor’s attestation of management’s assessment of the effectiveness of internal control over financial reporting as the audit of reporting control over financial reporting?

Yes. Footnote 3 is clear and makes sense. If the opinion is on the effectiveness of internal control over financial reporting, then there is no need to make the definition longer and more cumbersome by speaking of the „audit of the effectiveness of internal control over financial reporting“. Similarly, an audit of financial statements is not called an “audit of the fair presentation, in all material aspects in conformity with GAAP of financial statements”.

Q 2.: Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

Due to the knowledge about the company, inherent risk and control risk that is gained from an audit of internal control over financial reporting, there are economies in the time needed to conduct an audit of financial statements. These economies may also be partially used through intense communication between the audit team members conducting the audit of internal control over financial reporting and the audit team members conducting the audit of financial statements.

While I see no compelling reason for such a prohibition, section 404 of the Sarbanes-Oxley Act of 2002 clearly states “each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. … Any such attestation shall not be the subject of a separate engagement”. Therefore, I think it was congress’ intent that the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements.

Q 3.: Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit?

The auditor need not be required to also complete an audit of the financial statements. However, there should be an obligation for the auditor to use the knowledge about the company, inherent risk and control risk that is gained from an audit of internal control over financial reporting during his audit of financial statements. This knowledge may be obtained through assigning one or more members of the same audit team, verbal communication or documentation such as work papers. If this knowledge is not used, there is a duplication of work because the same knowledge is needed to determine the extent of substantive tests during the audit of financial statements. There is a significant overlap between the audit of internal control over financial reporting and the audit of financial statements. Not considering this overlap would be disastrous for the efficiency of the combined audit. This obligation should be mentioned in both, the audit standard concerning an audit of internal control over financial reporting and the audit standard concerning an audit of financial statement.

You may find the following legal intent of the Senate Committee on Banking, Housing and Urban Affairs that inserted section 404 into the bill useful "… the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees. High quality audits typically incorporate extensive internal control testing. The Committee intends that the auditor's assessment of the issuer's system of internal controls should be considered to be a core responsibility of the auditor and an integral part of the audit report."[7]

Q 4.: Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at small and medium-sized issuers?

I recommend inserting a company's size as one of the matters that affects the auditor's procedures before the matter industry. I believe that Appendix E is clear and appropriate.

In addition, there should be a reference to the Appendix on small and medium-sized issuers in the sections on documentation (sections 43–47).

Q 5.: Should the Board, generally or in this proposed standard, specify the level of competency and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

No. I do not think that detailed rules concerning university degrees or a number of years of experience in auditing financial statements can provide an adequate standard. However, there should be a general requirement to evaluate the competence of audit team members during audit planning. Audit team members should only be assigned to tasks for which they are sufficiently competent.

Q 6.: Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

Yes. The auditor needs to evaluate management's assessment. To do this he needs to reperform a part of the tests of controls done by management and to perform tests of controls (i.e. transactions) not included in management's sample. In addition, if the auditor does not agree with management's assessment of inherent and control risk, he needs to perform further tests of controls.

Q 7.: Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

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[7] Senate Committee on Banking, Housing and Urban Affairs, Report of the Senate Nr., Title-by-title-summary of major provisions, Title IV Enhanced Financial Disclosures, Section F. Management assessment of internal controls,

Yes. However, I see no need to include documentation of controls over safeguarding of assets as a separate bullet point. Controls over safeguarding of assets are already included by other bullet points, such as control to prevent or detect fraud and segregation of duties, or controls over relevant assertions related to all significant accounts.

Q 8.: Is it appropriate to state, that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise the level of significant deficiency or material weakness in internal control?

Yes. It is appropriate that it is just a deficiency and not automatically a significant deficiency or a material weakness.

Section 46 about inadequate documentation of the design of controls is ok. However, there is no paragraph about the consequences of inadequate documentation of the operation/testing of controls. In my opinion, missing documentation can be compensated by the auditor through inquiries and observation of the persons responsible for testing, reperformance of testing according to inquiries and by sample testing.

In general, I propose a different order of the sections on documentation. Section 45, which should describe the purpose of documentation and emphasize that documentation is not an end in itself but just a means to an end, should be placed before section 43 (criteria for contents of documentation).

I also recommend putting section 44 (forms and extent of documentation) after section 45 and before section 43 and to refer to the appendix for small and medium sized companies.

Q 9: Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

Yes. Walkthroughs make sense for really understanding processes and what employees really understand and actually do. This is more pervasive evidence than just reading a written policy or procedure.

Q 10.: Is it appropriate to require the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use the walkthrough procedures performed by management, internal auditors, or others?

No. In principle, the auditor should be allowed to use documented walkthroughs performed by management, internal auditors and others. As mentioned in my response to question no. 12, the extent of the use of documented walkthroughs should be based on a risk assessment.

Q 11.: Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditors use some of the audit evidence

obtained in previous years to support his or her current opinion on management's assessment?

No. To promote audit efficiency, the auditor should be allowed to use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment. I recommend using a "baseline" audit approach. That means once the effectiveness of a control has been tested, the emphasis should be on tests of significant changes to this control that occurred later. If an application control in the accounting system (e.g. SAP) that provides a three-way-match has been audited in the first year, only a check, whether customizing tables or master data tables, which relate to the three-way-match, have been changed, should be required. However, due to the Use of Professional Scepticism in section 111, there should be at least a limited (i.e. a smaller sample than the first year) reperformance of tests of manual controls because the same employee could have become complacent, distracted or otherwise not carry out his or her responsibilities.

Q 12.: To what extent should the auditor be permitted or required to use the work of management and others?

The extent should not be determined by fixed categories of control, but by an assessment of inherent risk and control risk as in SAS No. 65. Inherent risk is mostly based on materiality, which is in turn based on the amount, its subjectivity (degree of estimates and judgements required) and the probability of a misstatement. Control risk is based on the competence and objectivity of management and others (e.g. internal auditors) and the quality and effectiveness of the work (i.e. tests of controls) performed by management and others.

Consequently, there is a sequential approach for determining the extent of the work of others:

1.) Assess inherent risk. The result of this assessment has an impact on the extent of the sample size for tests of controls.
2.) Assess the competence and objectivity of management and others (e.g. internal auditors). The result of this assessment has an impact on the extent of the sample size for tests of controls.
3.) Assess the quality and effectiveness of the work of management and others by assessing their assessment of inherent and control risk, the result of the assessment has an impact on the sample of the tests of controls performed by management and others that needs to be reperformed by the auditor and his sample of tests of controls which were not included in the sample selected by management and others. If the auditor does not agree with management and other's assessment of inherent and control risk (i.e. their sample size) or does not agree with their objectivity (i.e. believes they have deliberately selected a "clean" sample to be presented to him), he should increase the sample of tests of controls which were not included in the sample selected by management and others.
4.) Assess the quality and effectiveness of the work of management and others by reperforming a sample of the tests of controls performed by management and others and by performing tests of controls, which were not included in the sample of management and others.

I recommend to explicitly include this sequential approach and to include more language and tests from SAS No. 65 or more references to SAS No. 65 which already uses risk based approach.

Q 13.: Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

No. As I mentioned in my response to question nr. 12, I believe that a risk based approach is better than the fixed three categories of controls.

The proposed standard does not disclose reasons why the auditor should not use the results of testing performed by management and others in the category of controls described in section 104 or why his use of testing of should be limited in the category of controls described in section 105 of the proposed standard. Possible reasons could be a general distrust of management's or the internal auditors' independence or a general distrust of the competency of management's or the internal auditors in complex financial accounting issues.

In general, I do not see a reason why work performed by an internal auditor who has been assessed to be competent and objective by the auditor should not be trusted. In addition, even the work of management and others should be trusted if the auditor has assessed the whistleblower controls to be effective.

If internal audit reports directly to the audit committee and if effective whistleblower procedures have been implemented that allow employees to report suspected fraud to the audit committee, I see no reason why the auditor should not use the testing of internal audit of controls specifically established to prevent and detect fraud. In addition, a lot of the controls that are part of the control environment are "soft controls" which relate to employee perceptions. Those controls are typically tested through employee questionnaires. The analysis of those questionnaires and the communication of conclusions to the audit committee can also be effectively performed by internal auditors.

Furthermore, I see no reason why testing of controls over the period-end financial reporting process performed by internal auditors that are competent in financial reporting and IT should not be relied upon in principle. In modern ERP systems, transaction totals do not need to be entered into the general ledger manually. A posting of a transaction to a subledger is automatically posted to the general ledger in the same posting because the database record of the posting contains both a field for the account nr. in the subledger and a field for the account number in the general ledger. In addition, most consolidating adjustments are automated through partner intercompany codes in consolidation systems.

Moreover, IT auditors of internal audit are competent to assess information technology general controls on which the operating effectiveness of other controls depend. They may even be more qualified than the external auditor because of their in-depth knowledge of the IT systems and their customisation by the company. The same ERP system can be customized quite differently at different companies. As a consequence, it is harder for the external auditor to know the customizing at each client than for the internal auditor to only know the customizing at his company.

I find it hard to see why a walkthrough that was documented by internal auditors in sufficient detail should not be used by the auditor if the conclusions drawn form the walkthrough that were used to determine the size of the sample tested by internal auditors are also properly documented. A walkthrough can be quite time consuming. Its main purpose is to gain an understanding of the design of controls and its understanding by employees.

In addition, if the competency of an internal auditor in financial accounting has been assessed as high, the auditor should be able to fully use the work of internal auditors concerning accounts involving significant judgments and estimates because they are qualified to challenge management's judgments and estimates and can report disagreements to the audit committee in the same way the auditor could.

Q 14.: Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Yes. Section 108 gives appropriate recognition to the work of internal auditors.

I propose to place section 107 on preconditions to using the work of others and section 108 on internal auditors directly after section 103 to emphasize the risk based approach.

Q 15.: Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?

No. As I mentioned in my responses to questions no. 12 and 13, fixed categories of control do not offer an appropriate flexibility in determining the extent of reperformance of the work of others. I recommend that the standard explicitly requires the auditor to reperform a sample of the tests of controls selected by management and others and to perform a sample of tests of controls not selected by management and others, but that it does not require a fixed sample size.

Q 16.: Is the requirement that the auditor to obtain the principal evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

No. I am concerned that this requirement may be interpreted to mean to require reperformance of the majority of the sample of the tests of controls performed by management and others or as an excuse to increase audit fees. However, as in SAS No. 65, I agree that the auditor retains the final responsibility for his opinion and the extent of the use of the work of others and the audit risk is his judgment.

Q 17.: Will the definitions of the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Yes. I think so. However, the definitions of significant deficiency and material weakness need interpretation and will always be subject to professional judgement.

Q 18.: Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

No. In my opinion, the examples in appendix D need to be improved to provide helpful guidance.

Example D-1 is not good because it relates to intercompany transactions. Materiality is considered based on consolidated amounts. Intercompany amounts get eliminated by consolidation. They primarily relate to balance sheet activity and their effect is an increase or a decrease in assets or liabilities. As a consequence, only non-reconciling intercompany amounts can have an effect on the consolidated amounts. In addition, it does not explain why the amount is significant and not inconsequential. It only mentions a significant number of transactions and that the individual transactions are not material but not why the combination of the two results in an amount that is significant. I recommend more details in this example.

There is no explanation in example D-2 why a change in shipping terms can cause a delay in revenue recognition. The new shipping term would need to be a shipping term that transfers the significant risks and rewards of ownership to the buyer after the time of shipment from the seller's warehouse/premises. E.g. CIF port of destination in order to cause a change in the timing of revenue recognition. Again, I recommend more details in this example

Q 19.: Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

Yes it is necessary to evaluate the severity of all identified internal control deficiencies. I think that this evaluation is the basis for the auditor's judgement if the deficiency is a significant deficiency, a material weakness or just a deficiency.

Q 20.: Is it appropriate to require the internal auditor to communicate all deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

Yes. Material weaknesses and significant deficiencies should be communicated to management and the audit committee. All other deficiencies should only be communicated to management. Since there is an evaluation whether something is a deficiency or nothing at all, I do not see a problem there.

Q 21.: Are the matters that the Board has classified as indicators that a material weakness in internal control exists appropriately classified as such?

Yes, I think so.

Q 22.: Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Yes. I believe that investors would be very interested to read about the non-effectiveness of the audit committee's oversight in the audit report.

Q 23.: Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

Yes. I think they will be able to carry it out trough interaction with the audit committee, inquiry and reviewing documentation. However, there may be an independence problem for the auditor since he gets appointed and compensated by the audit committee.

Q 24.: If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

No. I believe that issuing an adverse opinion and disclosing the material weakness provides more relevant and timely information to investors than simply withdrawing from the engagement.

Q 25.: Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

Yes. Consistency with the required management report is important in order to not confuse investors.

Q 26.: Are there circumstances where a qualified "except for" conclusion would be appropriate?

That depends if public disclosure of significant deficiencies is intended.

Q 27.: Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

Yes. This is more meaningful to investors.

Q 28.: Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?

Yes. Guidance on internal control-related non-audit services would be useful. E.g. general Sarbanes-Oxley training. Help in documenting controls. Help in management's self assessment (which is effectively internal audit). However, giving advice how much documentation is likely to be needed for the audit should be permitted.

Q 29.: Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Internal audit services and internal control consulting services should be prohibited as required by the Sarbanes-Oxley Act. However, it should be permitted that the client can ask his auditor about his understanding of how to apply rules and regulations on internal control. This is an important element of the coordination between the client and his auditor to preempt later problems due to a different interpretation/opinion of the auditor.

Q 30.: Are the auditor's different levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certifications, appropriate?

The auditor attests to Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year contained in management's annual report on internal control over financial reporting required by Item 308 (a) of Regulation S-K, but not to management's certification required by section 302 of the Sarbanes-Oxley Act and not to the disclosure of changes in internal control over financial reporting required by Item 308 (c) of Regulation S-K.

In my opinion, there is no statutory authority and legal intent to require limited audit procedures for internal control over financial reporting for quarterly reports. Section 404 (a) of the Sarbanes-Oxley Act states that "The Commission shall describe rules requiring each *annual* report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 USC 78m or 78o(d)) to contain an internal control report …" (emphasis added). To me it seems congress' intent was to only have an *annual* audit of internal control over financial reporting. In addition, section 302 of the Sarbanes-Oxley Act does not require management's certifications to be audited. Furthermore, the registered public accounting firm's attestation report that is required by Regulation S-K Item 308 (b) only refers to Management's annual report on internal control over financial reporting required by Item 308 (a) and not to the disclosure of changes in internal control over financial reporting required by Item 308 (c). Consequently, there is also no statutory authority and legal intent to audit the disclosure of changes in internal control over financial reporting.

As a consequence, I recommend removing "and the auditor" from footnote 20 to section 151 and removing the sections 183-189 (Auditor's Responsibilities for Evaluating Mangement's Certification Disclosures About Internal Control Over Financial Reporting).

If management discovers a material weakness in internal control during the year and fixes it before the end of the year, the auditor should only be required to audit the effectiveness of the fixed control. If it is effective, management is allowed to conclude that internal control over financial reporting is effective as of the end of the year.

Although the auditor's opinion on the effectiveness of internal control over financial reporting is *as of the end of the year*, he will also need to make tests of controls *during the year*, but for purposes of expressing an opinion on the fair presentation of financial statements in conformity with GAAP.

Q 31.: Is the scope of the auditor's responsibility for disclosures about the internal control over financial reporting appropriate?

No. Please refer to my answer to question 30.

3. Comments on individual sections of the proposed audit standard

Section 13 (Committee of Sponsoring Organizations Framework)

The standard should explicitly mention the other frameworks mentioned in the SEC's final rule 33-8328 as examples of suitable frameworks (i.e. Assessing control/Criteria of Control by the Canadian Institute of Chartered Accountants and Turnbull by the Institute of Chartered Accountants of England and Wales) in section 13.[8]

Section 14 (Committee of Sponsoring Organizations Framework)

I think it is potentially misleading to use the term "accounting controls" in section 14 because it may be confused with "internal accounting controls" which is the old term for "internal control over financial reporting". If controls typically performed by the accounting department are meant, then they should be called so. A lot of controls which are typically performed by other departments than the accounting department materially affect financial reporting (e.g. a review of overdue open purchase orders by the purchasing or receiving department may reveal that goods receipts for shipments have not been posted and that inventories and liabilities are misstated; a review of overdue open production orders by the production planning department may reveal that production progress confirmations have not been posted and that work-in-process and expenses are misstated, reports by the legal department may be the basis for estimates for provisions for liabilities linked to lawsuits and for disclosures about open and terminated lawsuits).

Section 15 (Inherent Limitations in Internal Control over Financial Reporting)

I recommend including the concept of a cost-benefit-balance, which is linked with the concept of *reasonable* not absolute assurance, as one of the inherent limitations in internal control over financial reporting (see Internal Control – Integrated Framework Executive Summary, page 3) in section 15. There are cases when the cost of a control is prohibitively high compared to the risk of misstatement. It is important to avoid the perception that controls are an end in itself instead of a means to an end.

Section 24 (Fraud Considerations in an Audit of Internal Control Over Financial Reporting)

Section 24 speaks of the "prevention, identification, and detection of fraud". What is the difference between identification and detection? This seems duplicative and may be confusing. I recommend removing "identification". Similarly eliminate "deter" in section 25 since both preventive controls and the knowledge of the existence of detective controls act as a deterrent.

Section 50 (Obtaining an Understanding of Internal Control Over Financial Reporting)

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[8] SEC Final Rule 33-8328, S. 93, footnote 67 in chapter II, section B, 3.a,
http://www.sec.gov/rules/final/33-8238.htm

To me, the meaning of “For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor’s understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit” in section 50 Control is somewhat unclear. Does it mean that control activities that were not considered in a financial statement audit because the time to test those controls was not justified by the time saved by reduced substantive tests under previous AICPA audit standards? I believe this is a general principle and that the sentence should be removed from this specific section and moved to another more appropriate section.

In addition, I recommend to move the last sentence in the Information and Communication bullet point to the end of the Control Activities bullet point. Controls over the safeguarding of assets, the processes for authorization of transactions, the maintenance of records and the period-end financial reporting process are part of the control activities element rather than the information and communication element of internal control.

Section 99 (Timing of tests of controls)

I think the need for an evaluation of superseded controls depends on the interpretation of investors and the PCAOB whether the concept of concluding on the effectiveness of internal control over financial reporting as of a certain date only applies to this point in time or applies to a time period. In any case, I strongly recommend adding “However, the auditor needs to evaluate superseded controls for the purpose of expressing an opinion on the financial statements because ineffective superseded controls may have caused material misstatements in the financial statements.”.

Section 144 (Effect of Substantive Procedures)

I recommend an addition to section 144 that would provide further clarification. Substantive procedures at a certain point in time give assurance that the output of a process was correct at that point in time. However, the reason for this may have been pure luck that existed at this point in time and not due to effective controls in the process. Only a test of the design and operation of controls can provide reasonable assurance that controls are effective to provide reasonable assurance that the process results in a correct output.

Appendix C Safeguarding of Assets

I recommend including decisions to incur expenditures at prices that prove not to be the best price, in addition to decisions to incur expenditures for unnecessary, unsatisfactory or unproductive goods in section C3. It may be beneficial to start section C3 with the fact that the concept of safeguarding of assets does not include controls over bad management decisions that decrease existing and newly acquired assets as long as they are processed correctly in the accounting records.

It is important to define if controls to prevent or detect fraud that involves sales at unauthorized prices or expenditures at prices which are higher than prices of other bidders with or without kickbacks to company employees (i.e. sharing a part of the misappropriated assets) are included in the definition of safeguarding of assets and the audit of internal control over financial reporting. Since controls over competitive bidding to prohibit procurement fraud are very time consuming and expensive, I wonder where the line for reasonable assurance should be drawn. If expenditures for outgoing freight are high due to a purchasing fraud, does this result in a misstatement of the financial statements? In a way the money has been spent on freight, but part of it was unnecessary. I believe if the fraudulently gained amount is significant, there is a material misstatement of the financial statements, because investors would be interested in a footnote disclosure how much was due to the fraud and will be non-recurring in future years. However there is still a cost-benefit dilemma for the company, its internal auditors and the external auditor. I guess ratio-analyses and trend analyses which show indicators for fraud could be cost-efficient.