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

RE: PCAOB Rulemaking Docket Matter No. 008
Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

Dear Mr. Secretary:

McGladrey & Pullen, LLP is pleased to submit written comments on the proposed auditing standard, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers.

Although we do have some suggestions that we believe would improve the proposed standard, we want to acknowledge the substantial effort by the Board and its staff in drafting the proposed standard, as well as applaud the result. Overall, the proposed standard is well thought out and, in our opinion, strikes an appropriate balance between the work effort required to support management's assessment and the work effort required to support the auditor's attestation. We also want to acknowledge the significant contribution of the Auditing Standards Board in submitting its recommendations concerning this proposed standard to the PCAOB.

Executive Summary

Evaluating Controls over all Relevant Assertions Related to all Significant Accounts and Disclosures

The proposed standard provides, in paragraph 41, that in order to evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures. The proposed standard further provides, in paragraph 69, that the auditor should identify the points within each significant process where a misstatement related to each relevant financial statement assertion could arise, and in paragraph 74, that the auditor should obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures. These requirements appear to ignore the concept of *inherent risk, i.e., the susceptibility of an assertion to material misstatement, assuming there are no related controls*, set forth in the interim auditing standards adopted by the Board (see AU 312.27-.29).

Accordingly, we do not believe that these requirements should extend to each/all relevant assertions when inherent risk for those assertions has been appropriately assessed as low. However, consistent with the requirements in the interim auditing standards to perform substantive tests for all significant accounts and disclosures, we do support a requirement to identify potential misstatements and evaluate and test controls for all significant accounts and disclosures.

Performing Walkthroughs

We support a requirement to perform walkthroughs. However, the proposed standard provides, in paragraph 79, that for significant processes, the auditor should trace all types of transactions and events through the process, from origination through the company's information systems until they are reflected in the company's financial statements. We believe that the requirement to trace all types of transactions and events is unnecessary and overly burdensome because certain types of transactions and events that are not individually significant are processed through significant processes.

Extent of Tests of Controls

The proposed standard, in paragraph 101, requires that each year the auditor must obtain *sufficient* evidence about whether the company's internal control over financial reporting is operating effectively. However, we believe that, consistent with the interim auditing standards for financial statement audits adopted by the Board (see AU 319.97-.98), evidence obtained about the effective design or operation of controls that was obtained in prior audits can be considered by the auditor in determining the nature, timing and extent of evidence required in the current audit. In any event, the auditor would always need to obtain evidence about whether changes in controls have occurred subsequent to the prior audit and obtain sufficient evidence about the controls continued operating effectiveness in the current audit. In determining the extent of evidence required in the current audit, the auditor should consider the significance of the assertion and account or disclosure involved, the nature of the controls, the degree to which the controls were evaluated in the prior audits, and the results of the tests of controls performed in prior audits.

Relationship of an Audit of Internal Control to an Audit of Financial Statements

The proposed standard, in paragraph 138, states, "Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement." While we agree with the second sentence, we believe that the first sentence mischaracterizes the requirements for an audit of financial statements contained in the interim auditing standards adopted by the Board (see AU 312.32 and AU 319.107). Those standards only require that an auditor perform substantive tests for significant account balances and classes of transactions, not for each relevant assertion within those accounts or classes. We assume it was not the Board's intent, and we do not believe that it would be appropriate, to make such a significant modification to the financial auditing standards through the issuance of this standard.

Documentation of the Effect of a Conclusion that Control Risk is Other than Low

The proposed standard, in paragraphs 146 and 147, requires an auditor to document the reasons for a conclusion that control risk is other than low for any relevant assertions for any significant accounts and the effect of that conclusion on the auditor's opinion on the effectiveness of internal control over financial reporting. We believe that an auditor should not be required to specifically test controls over all relevant assertions if inherent risk with respect to that assertion is appropriately assessed as low. Accordingly, the auditor would not have a basis for assessing control risk as low. In such cases, we believe that the auditor should be required to document the basis for the inherent risk assessment rather than the reason for and the impact of the control risk assessment. This comment should be read in the context of our preceding comments.

Effect of a Material Weakness on the Auditor's Report

The proposed standard, in paragraph 162, requires the auditor to express an adverse opinion on the effectiveness of internal control over financial reporting if a material weakness is identified. The SEC's rules implementing Section 404 of the Sarbanes-Oxley Act preclude management from concluding that internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting. Regardless of whether management must then conclude that internal control over financial reporting is not effective or is permitted to qualify its assessment, we do not believe the public interest is served by the auditor being required to issue an adverse opinion. We believe, as with an identified material misstatement of the financial statements, the auditor should apply professional judgment to determine whether to issue a qualified or an adverse opinion. A qualified opinion might be appropriate, for example, if the material weakness affects only one process and the resulting risk of material misstatement is limited to specific account balances, classes of transactions or disclosures.

Authoritative Appendices

We believe that appendices should be reserved for interpretive guidance and should not be used for standards. Accordingly, we believe it is inappropriate to include imperative statement or otherwise imply that any particular procedures are required in the appendices.

Responses to Questions

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

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 internal control over financial reporting?**

   Yes. We believe that it is appropriate because the term *audit* is better understood by the public and the objective, procedures and assurance provided in attesting to management's assessment of the operating effectiveness of internal control are substantially the same as the objective, procedures and assurance provided in an audit of financial statements.

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?**

   Yes. The Sarbanes-Oxley Act of 2002 specifically provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. It is clear therefore, that Congress intended that the audit of internal control and the audit of the financial statement s be conducted as an integrated audit. Because of the potential significance of information that might come to the auditor's attention in performing the audit of internal control to the audit of the financial statements (and vice versa), we concur that an auditor should be required to perform both audits concurrently.

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?

No. As previously noted, the Sarbanes-Oxley Act of 2002 specifically provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement (separate from the audit of the financial statements). In addition, we do not believe it would be possible to specify the nature, timing and extent of work that would be required to be performed in order for that work to be "comparable to that required to complete the financial statement audit".

Question regarding the costs and benefits of internal control:

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?

No. The standard should clearly state that the objectives of internal control at small and medium-sized issuers are the same as for larger issuers. In addition, we do not find Appendix E to be helpful in distinguishing between the types of controls that might be effective in small and medium-sized issuers and those that would be effective in larger issuers.

Question regarding the audit of internal control over financial reporting:

5. Should the Board, generally or in this proposed standard, specify the level of competence 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. Since the Board has proposed this standard as an auditing standard, engagements performed in accordance with this standard would be subject to the general and fieldwork standards, as well as the planning and supervision standards contained in the interim auditing standards adopted by the Board. Those standards require that the audit be conducted by persons with adequate technical training and proficiency, that due professional care be exercised in the performance of the audit, and that the work be adequately planned and assistants be adequately supervised.

Questions regarding evaluation of management's assessment:

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. In order to issue an opinion on management's assessment, the auditor must obtain evidence that management's assessment is accurate. It would be inappropriate for the auditor to issue such an opinion based solely upon an evaluation of the process used by management to make the assessment.

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

Yes. Absent such criteria, it would be difficult, if not impossible, for the auditor to understand and evaluate the process used by management to assess the effectiveness of the issuer's internal control over financial reporting.

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 to the level of significant deficiency or material weakness in internal control?

Yes. We do not believe that inadequate documentation would necessarily rise to the level of a significant deficiency or material weakness. As with any other internal control deficiency, the assessment of the significance of a documentation deficiency is a matter of professional judgment that should be made in consideration of the relevant facts and circumstances surrounding the deficiency.

Questions regarding obtaining an understanding of internal control over financial reporting:

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

Yes. Our firm has long required the performance of walkthroughs in audits of financial statements in order to confirm the accuracy of our understanding of the design of processes and controls and to determine that they have been placed in operation. Accordingly, we support the requirement in the proposed standard to perform a walkthrough for all of the issuer's significant processes. We do not, however, support the requirement to trace all types of transactions and events within a significant process from origination until reflected in the financial reports because we believe that requirement to be all encompassing and contrary to the overall objective of providing reasonable assurance on management's assessment.

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

Yes. Since the objective of walkthroughs is to confirm the auditor's understanding, we do not believe that the performance of walkthroughs can be delegated to others.

Question regarding testing operating effectiveness:

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 auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

No and yes. We believe that the auditor should be required to obtain evidence of the effectiveness of controls for all significant account balances and disclosures, but not necessarily all relevant assertions within each significant account balance or disclosure, each year. Because we believe the concepts of reasonable assurance and audit risk apply to audits of the effectiveness of internal control over financial reporting performed in conjunction with an audit of financial statements, we believe that evidence of operating effectiveness obtained by the auditor in recent prior years should be considered by the auditor in determining the nature, timing and extent of evidence to be obtained in the current year.

Questions regarding using the work of management and others:

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

Except for the performance of walkthroughs and the evaluation of the control environment, we believe the auditor should be permitted, but not required, to use the work of management and others, provided the auditor has concluded that their competence and objectivity warrants such reliance. In certain cases, we believe the auditor's use of management and others should be limited, and we agree that the auditor must obtain the principal evidence to support his or her opinion.

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

Yes. However, we believe that the auditor's use of the results of procedures performed by management and others for "controls over the period-end financial reporting process" and "controls that have a pervasive effect on the financial statements" should be limited rather than prohibited. For these two categories of controls, the in-depth understanding and technical competence possessed by these individuals may be critical to performing an evaluation of the effectiveness of such controls, and in the presence of an effective control environment, they should be in a position to objectively perform the procedures.

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. We believe that the proposed standard appropriately recognizes that, for issuers whose internal auditors are highly competent and objective, the auditor may place increased reliance on their work, while also cautioning the auditor that, in some cases, the competence or objectivity of internal auditors may be insufficient to warrant increased reliance.

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)?

Yes. The extent of the reperformance will depend on a variety of factors, including the auditor's assessment of the competence and objectivity of the persons who performed the work, as well as the auditor's assessment of the importance of the control and the likelihood that it might fail to perform as designed.

16. Is the requirement for 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?

Yes. We strongly believe that, in all cases in which an auditor expresses an opinion, the auditor's own work should provide the principal basis for that opinion. This requirement provides an appropriate overall limit on the auditor's ability to use the work of management or others.

Questions regarding evaluating results:

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

No. It appears that the intent was to characterize a *significant deficiency* as a deficiency that results in more than a remote likelihood of *a misstatement that is not inconsequential* and a *material weakness* as a deficiency that results in more than a remote likelihood of *material misstatement*. However, as written, there is an inadequate distinction between *significant deficiency* and *material weakness*. Following are our suggestions on how these two definitions could be improved:

> A *significant deficiency* is an internal control deficiency, or combination of deficiencies, that adversely affect the company's ability to initiate, record, process or report external financial data to a degree that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
>
> A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

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?

Yes and no. Our experience has shown that, once you go beyond simple examples, it is impossible to provide sufficient facts for competent professionals to consistently reach the same conclusion. Accordingly, we recommend that additional examples not be provided.

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

Yes. Once an auditor identifies an internal control deficiency, the auditor needs to evaluate whether it is a significant deficiency or a material weakness.

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

No. For internal control deficiencies originally identified by others, the auditor should be required to determine that management has been informed of the deficiency, but should not be required to re-communicate the deficiency or to reference the prior communication. However, an auditor should be required to communicate to management all internal control deficiencies originally identified by the auditor in the audit of internal control or the audit of the financial statements. Management, not the auditor, is responsible for evaluating the cost/benefit relationship of responding or not responding to internal control deficiencies. An auditor who makes a conscious decision not to communicate to management internal control deficiencies originally identified by the auditor has assumed a management responsibility.

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

Yes, for the most part. However, we believe that the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control should be included in this category. In addition, we believe that an ineffective regulatory compliance function would result in a significant deficiency (and a strong indicator of a material weakness) only if it has a direct or material indirect effect on internal control over financial reporting. Finally, we believe that it is an over generalization to conclude that fraud *of any magnitude* on the part of senior management should be included in this category, especially if it was detected by the company's internal control.

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, however, we believe the proposed standard should make it clear that in order to have a sufficient basis for its assessment, management would also need to evaluate the effectiveness of the audit committee's oversight.

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

Yes. Provided the standard is clear that the auditor is not expected to make a legal evaluation, auditors have the objectivity and technical competence to make this evaluation. In addition, we suggest the auditor's responsibility to evaluate the independence of the audit committee be limited to consideration of observable information and behavior.

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. In these circumstances, the auditor should not be required to withdraw from the audit engagement. The public interest would be better served by the auditor issuing an adverse opinion on the effectiveness of internal control over financial reporting, and potentially a disclaimer of opinion on the financial statements, as a result of ineffective audit committee oversight than by the auditor's withdrawal from the engagement(s).

Questions regarding forming an opinion and reporting:

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?

No. When the financial statements are materially misstated, the auditor evaluates the significance and the pervasiveness of the misstatement in deciding whether to express a qualified or adverse opinion. Similarly, we believe that when a material weakness is identified, the auditor should evaluate the significance and pervasiveness of the resulting risk of material misstatement, and in his or her professional judgment, determine whether to express a qualified or adverse opinion.

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

Yes. We believe that where the potential for material misstatement of the annual or interim financial statements is neither overwhelmingly material nor pervasive to the financial statements taken as a whole, a qualified opinion would be appropriate because it adequately informs the public of the risk of material misstatement.

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. We do not believe that it would serve the public for an auditor to be permitted to express an unqualified opinion on management's qualified assessment or to issue a qualified opinion on management's unqualified assessment. Accordingly, in those circumstances, an auditor's report should speak directly to the effectiveness of internal control over financial reporting.

Questions regarding auditor independence:

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

No. We do not believe that this proposed standard is the appropriate place for guidance on independence and internal control-related non-audit services. We believe that the issue of auditor independence related to internal control services should be viewed in the broader context of overall auditor independence.

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

Yes. We believe that independent auditors can provide non-audit internal control-related services to their clients, with appropriate audit committee pre-approval, and within strict parameters that do not place the auditor (a) in the position of auditing his or her own work, or (b) in the capacity of management or an employee of the audit client. However, we believe that an auditor should not perform the following specific non-audit services for his or her audit client because they violate these overarching principles:

- Designing, implementing, operating or supervising the operation of any element of an audit client's internal control over financial reporting.
- Performing any internal audit services that relate to internal controls over financial reporting.
- Designing or implementing software or hardware systems that aggregate source data underlying the financial statements or generate information that is significant to the audit client's financial statement taken as a whole.

- Assuming responsibility for documenting the client's internal control over financial reporting.
- Performing the evaluation required of management for purposes of its assessment of the effectiveness of internal control over financial reporting.
- Performing internal control testing required of management for purposes of its assessment, including situations where the auditor chooses sample size, decides on tests to perform, or provides software that concludes as to the effectiveness of controls.

Questions regarding auditor's responsibilities with regard to management's certifications:

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

Yes. A different level of responsibility is implicit in the level of responsibility the auditor assumes in a review of the interim financial statements versus an audit of the annual financial statements.

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

Yes, however, we do not believe that the requirements with respect to quarterly certifications should become effective until the first quarter after the annual assessment becomes effective.

Thank you for the opportunity to comment on this proposed standard. Questions concerning our comments should be directed to Bruce Webb, National Director of Auditing (515.281.9240) or Leroy Dennis, Executive Partner – Audit & Accounting (952.921.7627).

Very truly yours,

McGladrey & Pullen, LLP