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February 23, 2007

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

RE: Rulemaking Docket 021 -- *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007

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 That Is Integrated with An Audit of Financial Statements*, the proposed auditing standard, *Considering and Using the Work of Others in an Audit* and other related proposals. McGladrey & Pullen, LLP is a registered public accounting firm serving middle-market issuers.

McGladrey & Pullen, LLP supports the PCAOB's proposed auditing standard on internal control over financial reporting and the related proposals. Overall, we believe that these proposals will facilitate continued progress in upholding the investor protections that are so fundamental to the success of the Sarbanes-Oxley Act (the Act) and the market vitality that has been the result of its passage. These changes also will serve to improve the effectiveness and efficiency of the process related to the internal control assessment and attestation provisions of the Act. Overall, we believe that the proposed changes strike the right balance between cutting compliance efforts and costs and maintaining the significant benefits of Section 404 of the Act and the audit of internal control over financial reporting.

We expect the proposed changes, along with the proposals (File No. S7-24-06) by the Securities and Exchange Commission (SEC), will result in a reduction of total efforts and costs related to Section 404. We also believe that total cost reductions will likely vary based on facts and circumstances for each particular issuer, the state of its evaluation process of internal control over financial reporting, and the extent to which management already has effective internal control over financial reporting in place.

We also believe that the benefits from the SEC and PCAOB proposals will be greatest to issuers that have not yet initially implemented the requirements of Section 404. Although the effects of the new guidance will vary from issuer to issuer, the maximum opportunities for efficiencies and cost-effectiveness related to Section 404 are optimized when management and auditors work together to conduct the assessment and attestation in a complementary manner, and when the auditor can make effective use of management's work. We also believe that the cost of complying with Section 404 can be reduced as issuers and auditors become more experienced with the application of Section 404.

We support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment, and its decision to apply a single model of auditor reporting on internal control over financial reporting applicable to all public companies that is scalable to companies of varying size and complexity. We also support the PCAOB's position requiring auditors to obtain evidence regarding the operating effectiveness of controls to determine whether the controls in place actually work as intended. We also believe that requiring auditors to apply a risk-based approach to testing controls supports the reliability of the audit.

We also express our strong support of the PCAOB's project to develop guidance and education for auditors of smaller public companies. The project will facilitate scalability of the proposed standard in an effective and efficient manner for audits of these smaller issuers. The effective and efficient application of the proposed standard will depend heavily on the success of this project.

We appreciate the PCAOB's emphasis on more flexibility in determining the extent to which the work of others may be used by the auditor and believe that the changes in the proposed standard on internal control over financial reporting in this area, coupled with the existing interim standard "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322), can achieve the Board's objective of efficient and effective implementation of audits of internal control over financial reporting. We do not believe that the Board's proposed standard, *Considering and Using the Work of Others in an Audit*, that would supersede the existing interim standard is necessary, as it contributes little to the achievement of the Board's objectives in this area, and could actually weaken audit effectiveness through inappropriate use of the work of others. If however, the Board determines that it is necessary to have a new standard for considering and using the work of others in an audit, we believe the Board should incorporate certain concepts identified later in this letter, which are missing from the proposed standard, to ensure both effective and efficient implementation of integrated audits of the financial statements and internal control over financial reporting.

We recognize that there were various requests for comments within the PCAOB's Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements and Related Other Proposals*, however, we have limited our comments to the significant matters noted below.

While we are supportive of the direction of the proposed standards, particularly their increased emphasis on appropriate exercise of auditor judgment, we offer the following specific comments as suggestions to improve the proposed standards to meet the overall goal of making implementation of audits of internal control over financial reporting more effective and efficient.

Auditor's Use of Professional Judgment

As indicated previously, we support the PCAOB's increased emphasis and flexibility on the auditor's use of professional judgment. However, we note that by allowing the auditor to exercise a greater degree of professional judgment, there may be more inconsistency in applying the proposed standard in practice. As such, effective monitoring by the PCAOB inspections staff will be critical to promoting an appropriate degree of consistency by, and among, auditors.

Presumptively Mandatory Performance Requirements

While we support the objective of performing both an efficient and effective integrated audit of ICFR and of the financial statements, we note that the proposed standard includes presumptively mandatory performance requirements relating to engagement efficiency. We are concerned that the inclusion of these presumptively mandatory performance requirements may actually detract from the well-established objective of auditing standards which is to provide guidance for the conduct of a high quality audit.

Considering and Using the Work of Others

We believe that the changes in the proposed standard on internal control over financial reporting (ICFR) coupled with the current interim standard, *"The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"* (AU sec. 322) achieve the Board's objective of efficient and effective implementation of an integrated audit of the financial statements and ICFR. Accordingly, we do not believe that the Board's proposed standard, *Considering and Using the Work of Others in an Audit*, which would supersede AU sec. 322, is necessary as it will result in little additional efficiency. More importantly, we believe that the effectiveness of the audit of the financial statements could potentially be diminished by inappropriate use of the work of others.

On the other hand, if the Board decides that a new standard on using the work of others is necessary, one very important principle in AU sec. 322 that has not been included in the proposed standard relates to the auditor's ability to use the work of others, where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, and in particular the concept that in these circumstances, the auditor's evidence should not consist solely of the work of others. We recommend that the Board consider including paragraphs 21 and 22 of AU sec. 322 in the proposed standard to reinforce this important concept.

In addition, even though the "principal evidence" concept previously included in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* has been eliminated, the auditor must still be in a position to state in the opinion that he or she has audited the financial statements and management's assessment of ICFR. As noted in paragraph 9 of the proposed standard, *Considering and Using the Work of Others in an Audit*, judgments about the sufficiency of evidence obtained, assessments of risk, the materiality of misstatements, and evaluations of test results, must be those of the auditor. We believe that replacing AU sec. 322 with the proposed standard will likely lead to confusion regarding the auditor's implied obligation to obtain principal evidence to support the auditor's opinion.

Paragraphs 3 through 6 of the proposed standard, *Considering and Using the Work of Others in an Audit*, describe the auditor's responsibility to determine whether there are activities performed by others that can be used in connection with the audit. We believe that these paragraphs will likely lead to unnecessary effort being expended to look for activities significantly removed from those of internal auditors and similar groups described in AU sec. 322, which upon consideration, will not be useable because of issues related to competence and objectivity or are not tests that provide audit evidence as described in the proposed standard. Accordingly, we see no benefit to adding these paragraphs. If the Board decides to adopt the proposed standard, then we recommend that the discussion of competence and objectivity, as discussed in paragraphs 13 through 17 of the proposed standard, precede the consideration of relevant activities in order to more appropriately reflect the thought process of the auditor in considering the work of others. In addition, the Board should describe the extent of documentation considered appropriate to demonstrate compliance with paragraphs 3 through 6 of the proposed standard.

<u>Scaling the Audit</u>

We appreciate the guidance and requirements placed upon the auditor found in paragraphs 9 through 12 of the proposed standard on the audit of ICFR, and as indicated previously, we fully support the PCAOB's project to develop guidance and education for auditors of smaller public companies. While we agree that the size and complexity of the issuer should be evaluated when planning and performing the integrated audit, we note that the guidance and requirements in paragraphs 9 through 12 apply to integrated audits of all issuers, not just "smaller companies" as defined in the proposed standard. As such, we recommend that the "heading" preceding paragraphs 9 through 12 be changed from "Scaling the Audit for Smaller Companies" to "Scaling the Audit." This change would help mitigate the possibility that these important paragraphs of the proposed standard were omitted from consideration by auditors of issuers who do not meet the definition of a "smaller company." Lastly, we note that in paragraphs 9 through 12 of the proposed standard, the attributes of "size" and "complexity" receive approximately equal emphasis. We believe that paragraphs 9 through 12 should be revised to place more emphasis on the importance of considering the complexity of the issuer when scaling the audit as a "smaller" company may not be indicative of a "less complex" entity.

<u>Company-Level Controls</u>

We agree that the evaluation of company-level controls is an important part of a top-down, risk-based approach to the audit. However, while paragraph 43 of the proposed standard indicates that "some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions," there is no indication as to how frequently company-level controls can be linked directly to a relevant assertion. We do not disagree with the conceptual underpinning of the guidance provided in paragraph 43 of the proposed standard, however we do believe that the lack of guidance regarding the frequency with which these types of company-level controls may be expected to be encountered in practice potentially may lead auditors to search for non-existent controls of this nature. We believe that it would be a fairly infrequent situation where testing solely company-level controls without testing at least some lower-level controls would be sufficient because effective functioning of company-level controls is often dependent on the use of accurate and reliable data subject to lower-level controls. We recommend that examples be added to the guidance to illustrate the linkage and the benefit that might be derived from such controls in determining the nature, timing and extent of testing lower-level controls.

Consideration of Fraud and Company-Level Controls

We believe it is important that when an auditor assesses risk when planning the audit, that the interaction between the identified risks of fraud for certain assertions be addressed when scoping the audit of ICFR. We recommend that this notion be clearly articulated in the proposed standard. For example, we believe the Board should better articulate this notion in the interaction between the risk that the control might not be effective as described in paragraph 51 and whether the control is intended to address significant fraud risks. We also recommend that fraud be added to the list of factors that affect the risk associated with a control as articulated in paragraph 52 of the proposed standards.

Additional clarity with regard to the consideration of the precision of company-level controls as it relates to the risk of fraud would be helpful. In other words, we believe that the concept regarding company-level controls cited in paragraph 43 of the proposed standard should be reiterated earlier in the standard – around paragraph 17 – the section on Identifying Company-Level Controls – to better address the auditors' consideration of fraud and to better integrate fraud considerations consistent with the concepts in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Removal of "Large Portion" and "Principal Evidence"

We are supportive of the Board's guidance related to multi-location testing requirements which now focus on risk rather than coverage and also are supportive of the deletion of terms "large portion" and "principal evidence" from the proposed standard on ICFR. However we believe that the simple removal of this terminology from the proposed standard on ICFR does not change the auditor's requirement to obtain sufficient audit evidence to support the auditor's opinion. Accordingly, we recommend that the Board add guidance to the introductory section of the proposed standard on ICFR as well as the sections dealing with scoping of the integrated audit clearly articulating this very important requirement of the auditor. We believe that adding this wording will serve to bridge any "expectation gap" between management and the auditor that might result from the deletion of "large portion" and "principal evidence" from the proposed standard.

Roll-Forward Procedures

Paragraph 63 of the proposed standard on audits of ICFR, indicates that "When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what, if any, additional evidence concerning the operation of the controls for the remaining period is necessary." We note that included in this sentence are the words "if any," which appear to indicate that there are situations in which the auditor could conclude that no additional evidence or procedures are required to be obtained or performed to test the effectiveness of such controls over the remaining period. That is, in accordance with paragraph 63 of the proposed standard, there are situations where the auditor would not obtain any evidence regarding the operating effectiveness of controls as of the specific date being reported on (not even inquiry about changes in the design of controls since the date of interim testing). We believe that this guidance is in conflict with both interim auditing standard AU 313.08 (substantive tests) and interim auditing standard AU 319.99 (tests of controls in a financial statement audit). Both AU 313.08 and AU 319.99 indicate that at least some procedures (inquiry at a minimum) would need to be performed in order to extend conclusions reached at an interim date to the balance sheet date. As such, we believe that either the words "if any" should be removed from the guidance in paragraph 63 of the proposed standard or that more specific guidance and/or examples be added to the proposed standard illustrating under what circumstances no additional audit evidence would need to be obtained.

Strong Indicators of Material Weaknesses

We note that the description of strong indicators of material weaknesses differ between the Board's proposed standard on ICFR and the SEC's proposed management guidance. As we indicate in our letter to the SEC on its proposed management guidance, we believe that the SEC should conform its description to the PCAOB's description of such factors. Conforming the two documents will help to reduce potential confusion, inconsistencies, and possible inefficiencies that may occur as a result of these differences.

Definition of Material Weakness and Associated Reporting

We note that the definition of a material weakness has been changed from the definition provided under PCAOB Auditing Standard No. 2. We believe that when a material weakness exists, the definition of material weakness required to be included in the auditor's report on ICFR may cause confusion on the part of users of the auditor's report.

The sample "Scope paragraph" of the auditor's report on ICFR found in paragraph 96 of the proposed standard states in part –

> "Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances."

While the above sentence from the sample auditor's report on ICFR clearly states that the auditor only assesses the risk that "a material weakness" exists, when a material weakness is deemed to exist, the definition of material weakness required to be included in the auditor's report on ICFR as required by paragraph 100 of the proposed standard leads to confusion because the definition of a material weakness states in part that "A material weakness is a control deficiency, or combination of control deficiencies …" When reading the scope paragraph of the auditor's report on ICFR combined with the definition of a material weakness, a user could easily be led to believe that the auditor scoped the engagement to detect control deficiencies (not just material weaknesses) because a material weakness could be the result of the aggregation of more than one control deficiency and the auditor is charged with finding all material weaknesses.

While we acknowledge that paragraph 70 of the proposed standard clearly articulates that "the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness," we recommend that the scope paragraph of the auditor's report on ICFR be modified to clearly articulate that the auditor is charged with only detecting individual material weaknesses, but must evaluate whether less severe control deficiencies, if any, detected as a result of performing procedures to detect a material weakness aggregate to a material weakness.

Documentation

We are concerned that there may be possible unintended consequences relative to the interaction between the requirements of the proposed standard on ICFR and the Board's Auditing Standard No. 3, *Audit Documentation* as a result of the use of the words "should" and "must" throughout the proposed standard. For example, paragraph 51 of the proposed standard under the *Relationship of Risk to the Evidence to be Obtained,* includes a requirement that "[f]or each control selected for testing, the auditor should [emphasis added] assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result." Compliance with this requirement could generate a level of documentation relating to the auditor's assessment of risk that may not necessarily add to the level of effectiveness of the audit. Because each use of "should" or "must" potentially drives a documentation requirement, we recommend that the Board broadly reconsider the use of the word "should" and "must" throughout the standard to ensure that disproportionate auditor effort is not unnecessarily devoted to documenting consideration of items that would ordinarily be incorporated into the auditor's overall methodology. If the word "should" is used as a statement of fact, we recommend that alternatives to the word "should" be used by the Board so as to decrease any confusion regarding documentation requirements.

Effective Date

We believe that an effective date for the proposed standard(s) that would be least disruptive in practice would be to make the proposed standard(s) effective for audits of periods ending or after December 15, 2007. However, unless the proposed standard(s) are issued by the Board and approved by the Commission within 90 days, it may not be possible for our firm to work the changes through our methodology and tools and to sufficiently train our personnel to meet that objective.

Thank you for the opportunity to comment on these proposed standards. 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