

# McGladrey & Pullen

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February 20, 2009

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards*

Dear PCAOB:

McGladrey & Pullen, LLP (McGladrey) appreciates the opportunity to offer our comments on the *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*. McGladrey is a registered public accounting firm serving middle market issuers.

We support the Board's efforts to update its existing standards related to the requirements for assessing and responding to risks in an audit. We believe a risk-based approach for financial statement audits results in a more focused and effective audit, as well as one that is more efficient and scalable to companies of varying size and complexity.

Following are our comments that apply pervasively to the proposed standards, followed by specific comments on certain proposed standards.

## Eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards

Virtually all public accounting firms registered with the PCAOB also audit nonissuers. Unnecessary differences between the Board's standards and those for audits of nonissuers increase the costs of performing *all* audits because firms must develop and maintain dual audit methodologies and training programs. This also leads to confusion and misunderstanding by auditors of what is required of them and why, which potentially leads to an erosion of audit quality.

We believe these proposed standards are very similar to those of other standards setters, specifically the International Auditing and Assurance Standards Board's (IAASB) International Standards on Auditing (ISAs) and the AICPA's Statements on Auditing Standards (SASs), based

on the same principles supporting a risk-based audit. However, we are concerned there are many differences between the proposed standards and the ISAs and SASs that are unnecessary, or where it is not clear whether the Board expects a different action by the auditor. For example, Appendix 6 (Proposed Auditing Standard – *Consideration of Materiality in Planning and Performing an Audit*) requires the auditor to reassess the established materiality level and tolerable misstatement as the audit progresses. The ISAs and SASs contain a similar requirement, based on the same principle, but stated using different words. It is not clear what type of different action, if any, the Board expects of the auditor. Another example is the use of terms in the proposed standards such as “should evaluate”, “should determine” and “should assess,” where the comparable requirements in the ISAs and SASs use terms such as “should consider.” To the extent these different terms are intended to require a different level of performance and documentation, the differences and the purpose of such differences is unclear.

We recommend the Board use the same terms and language as found in the ISAs and SASs whenever it expects the same or similar action by the auditor. If a different action is expected, we urge the Board to clearly explain the different action expected so auditors understand what is required and the rationale for the difference.

We participated as a member of a task force assembled by the Center for Audit Quality (CAQ) to analyze these proposed standards and develop a comment letter reflecting the findings of the task force. The CAQ's comment letter contains other examples of unnecessary differences between the Board's standards and those of other standards setters with which we agree.

#### Exercise of sound professional judgment

There are several instances in the proposed standards where we believe requirements are overly prescriptive, which can result in inhibiting the auditor's use of professional judgment based on the unique facts and circumstances of each audit engagement. For example, Appendix 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*), paragraph 52, is constructed so that the auditor “should include” specific individuals and topics for inquiries about fraud. We believe this requirement could impede the auditor's use of judgment to determine the best individuals to whom fraud inquiries should be directed and the matters to be discussed. As another example, paragraph 27 of Appendix 3 requires the auditor to evaluate each control deficiency in the company's control environment to determine whether it is indicative of a fraud risk. While considering the impact of such control deficiencies on the auditor's fraud risk assessments is appropriate, we believe this requirement as stated is overly prescriptive and does not allow for the use of the auditor's judgment. Further, we believe this could lead the auditor to analyze each control deficiency individually, rather than considering them collectively and in light of other information.

Other examples are provided in the CAQ's comment letter to these proposed standards. We encourage the Board to use Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5) as a model, which allows considerable use of auditor judgment through its top-down approach for determining which controls to test.

In addition, we support the recommendation in the CAQ's comment letter that the Board consider developing a new standard similar to ISA 200 that describes the underlying objectives of the auditor and that provides a foundation for the auditor's use of judgment throughout the audit.

#### Integration of the financial statement audit with the audit of internal control over financial reporting (ICFR)

In many cases, and especially in Appendices 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*) and 4 (Proposed Auditing Standard – *The Auditor's Response to the Risks of Material Misstatement*), the proposed standards provide requirements and guidance for: (1) financial statement only audits, (2) audits of financial statements as part of an integrated audit, and (3) ICFR audits. In addition, AS 5 contains guidance that is relevant to financial statement only and integrated audits (for example, the use of the top-down approach and the identification of significant accounts and disclosures). We believe this format is confusing, and also suggests the risk assessment processes are different for different types of audits. We recommend the proposed standards be reorganized to support a single risk assessment process for all audits, including guidance currently in AS 5.

#### Integration with AU 316

We agree with the Board's approach to integrate certain requirements related to the auditor's consideration of the risks of fraud into the proposed standards. However, without a redrafted AU 316, it is difficult to analyze the Board's proposed changes. While we support the removal of "exculpatory language" from the existing AU 316, we believe the Board should retain as much as possible of the existing standard. We believe much of the guidance in existing standards is beneficial to auditors in implementing AU 316. A thorough and robust discussion about the nature and characteristics of fraud and the auditor's responsibilities for fraud enhances auditors' understanding of how to effectively implement the standard.

#### Finalization of standards

We support the Board's plans to issue a concept release in early 2009 indicating its plans to review its current interim standards, and we believe these proposed standards should not be finalized until the Board has exposed and received comments on that release.

#### Effective date of the standards

We encourage the Board to provide sufficient time between the issuance and effective dates of these proposed standards for firms to develop and execute an implementation plan, including revising their audit methodologies, software tools and quality control policies, and to develop and deliver training to audit personnel. We recommend that the standards be effective no earlier than audits of fiscal years beginning after December 15 of the year after the standards are issued.

### Codification

We encourage the Board to undertake a project to provide a codification of its standards. A codification would result in a standardized form and style for all of the Board's standards, facilitating understanding of the standards, including amendments, by all users.

### Standards-setting process

We encourage the Board to increase the openness and transparency of its standards-setting process. This can be achieved in a number of ways, including: (1) holding open meetings for discussion and debate of standards, (2) actively working with other standards setters to prioritize and coordinate agendas and to develop standards, and (3) providing detailed comparisons of the Board's proposed standards with comparable ISAs and SASs, as well as an explanation of why the Board decided to differ from those standards.

Increased openness and transparency will not only enhance auditors' understanding and timely implementation of the Board's standards, but it will also foster greater alignment of its standards with international auditing standards, as well as U.S. auditing standards for audits of nonissuers.


The following are our additional observations on specific paragraphs of the proposed standards:

- a. Appendix 3 (Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement), paragraph 22, second Note, last sentence requires that an inquiry of company personnel about whether a control has been implemented be combined with observation or inspection procedures. As such, the proposed standard does not allow for corroboration with a second inquiry. In certain cases, such as for controls related to management's commitment to ethical behavior, inquiries can be as or more effective than observation or inspection procedures for determining whether a control has been implemented; in other cases, inspection or observation procedures may not be practicable. We recommend that this proposed standard recognize that it may be appropriate to corroborate an inquiry with one or more additional inquiries. This is especially important in smaller companies where documentation of controls may be less formal.
- b. Appendix 3 (Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement), paragraph 39 states that if the auditor plans to modify the nature, timing or extent of risk assessment procedures based on information from prior audits, the auditor should determine whether prior year's information is relevant. While we agree with this comment, we suggest the Board provide additional guidance about the nature, timing or extent of risk assessment procedures needed for updating auditors' knowledge and information obtained in prior audits. We believe such guidance would improve audit efficiency, as well as the consistency and effectiveness of the risk assessment process for continuing audits.
- c. Appendix 3 (Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement), paragraph 62 refers to the risk of management override of controls. We suggest the Board consider providing guidance, such as that in paragraph 24 of AS 5, about the risk of management override of controls in smaller companies where there may be a lack of segregation of duties and where controls may be less formally documented.

- d. Appendix 4 (Proposed Auditing Standard – *The Auditor's Response to the Risks of Material Misstatement*), paragraph 45 requires the auditor to perform tests of details in response to significant risks. We believe the approach in existing standards, which allows a combination of substantive analytical procedures and tests of controls in response to a significant risk is preferable.

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to either Bruce Webb (515-281-9240) or Susan Menelaides (602-760-2827).

Sincerely,

A handwritten signature in cursive script that reads "McGladrey & Pullen, LLP".

McGladrey & Pullen, LLP