

Report on
2004 Inspection of McGladrey & Pullen, LLP

Issued by the
Public Company Accounting Oversight Board

November 30, 2005

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

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SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

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Preface to Reports Concerning Annually Inspected Firms

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("the Board") to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers. The Board's report on any such inspection includes this preface to provide context for information in the public portion of the report.

A Board inspection includes, among other things, a review of selected audits. If the Board inspection team identifies deficiencies in those audits, it alerts the firm to the deficiencies during the inspection process. Deficiencies that exceed a certain significance threshold are also summarized in the public portion of the Board's inspection report. The Board encourages readers to bear in mind two points concerning those reported deficiencies.

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements, or to take steps to prevent reliance on previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Second, the Board cautions against drawing conclusions about the comparative merits of these firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

2004 INSPECTION OF MCGLADREY & PULLEN, LLP

In 2004, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted an inspection of McGladrey & Pullen, LLP ("McGladrey" or "the Firm"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report, Appendix B, and portions of Appendix C. Appendix B provides an overview of the inspection process. Appendix C consists of the Firm's comments, if any, on a draft of the report.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

^{2/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") performed an inspection of McGladrey from October 2004 through December 2004. The inspection team performed field work at McGladrey's National Office and at four of its 75 practice offices, and, because McGladrey is a participant in an Alternative Practice Structure ("APS"), conducted interviews at another office of an entity involved in the APS. Appendix B to this report provides a description of the procedures the inspection team performed, and a brief description of the APS.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system. Appendix B to this report provides a description of the steps the inspection team took with respect to the review of audit engagements and the review of six functional areas related to quality control.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.^{3/} It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

^{3/} When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of selected audits performed by the Firm. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies. Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in one case, errors that appeared likely to be material to the issuer's financial statements. The deficiencies also included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions,^{4/} and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers. In some instances in which the inspection team identified GAAP departures, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.^{5/}

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. In some of those audits, that conclusion followed from the

^{4/} See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

^{5/} The Board inspection process generally did not include review of such additional procedures or documentation, or of such revised accounting, although future Board inspections of the Firm may, as appropriate, include further review of any of these matters.

omission, or insufficient performance, of a single procedure, while other audits included more than one such failure. The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis (without identifying the issuers).^{6/}

Issuer A

On this audit, the Firm failed to identify two departures from GAAP that it should have identified and addressed before issuing its audit report.^{7/} First, in one of its quarterly filings, the issuer included in income the gain on the sale of an operating property to a related party. Under Statement of Financial Accounting Standards ("SFAS") No. 66, *Accounting for Sales of Real Estate*, the gain should not have been recorded in income because the sale was to a related party.^{8/} Second, in its quarterly and annual filings, the issuer classified the results of operations of certain properties, and gains or losses on the sales of those properties, in discontinued operations. Because of the issuer's significant continuing involvement after the dates of the sales of these properties, however, they did not meet the criteria in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, for classification as discontinued operations.

The Firm also failed in other respects to obtain sufficient competent evidential matter to support its audit opinion. The Firm assessed control risk at the maximum, and it used analytical procedures to test revenue and certain operating expenses. For certain analytical procedures, the Firm failed to test either the data it used or the information system from which the data were derived. In addition, the Firm's documented expectations were not precise enough to provide the desired level of assurance that differences that may be material misstatements would be identified for the Firm to investigate. In addition, because the issuer had multiple properties, the Firm

^{6/} The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

^{7/} This issuer has restated its quarterly and annual financial statements to make changes relating to each of the items described here.

^{8/} The issuer corrected this error in the fourth quarter; however, the issuer did not restate its third quarter results at that time.

should have disaggregated the data when performing the analytical procedures, but the Firm failed to do so.

Issuer B

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to evaluate the issuer's compliance with its debt covenants at the first and second quarter measurement dates and failed to evaluate the issuer's ability to meet its debt covenants in future periods. Such evaluation was necessary to conclude that the classification of debt as long-term was appropriate given the issuer's violation of its debt covenants in the prior year, its debt-covenant violations during the second quarter, the scheduled debt maturities during the year, and the amendments to a debt agreement during the year. The Firm also failed to obtain corroboration of whether the conditions in an amendment to a debt agreement had been met for an executed debt waiver to be in place before filing the 2004 second quarter Form 10-Q.
- The issuer had violated its debt covenants, had a liquidity dependency on a maturing line of credit, and had insufficient cash to pay its current liabilities and maturing debt. Notwithstanding these matters, the Firm failed to evaluate, or failed to include evidence in the work papers that it had evaluated, whether there was substantial doubt about the issuer's ability to continue as a going concern for a reasonable period of time and, if there was, whether management's plans alleviated that substantial doubt. The issuer's 2004 quarterly and year-end financial statements did not disclose the impact of these conditions or events, or any mitigating factors, including management's plans to deal with them.
- The issuer used an outside service organization to process its payroll. The Firm placed no reliance on the service auditor's report on the service organization's internal controls and assessed control risk at the maximum for payroll expense. Nevertheless, the Firm failed to test the accuracy and completeness of the payroll reports from the service organization that the Firm used in its audit tests of payroll expense and related accounts. In

addition, the Firm used analytical procedures as the primary audit tests of payroll expense and related accounts; however, the procedures did not meet the requirements for substantive analytical procedures because the Firm's documented expectations were not precise enough to provide the desired level of assurance that differences that may be material misstatements would be identified for the Firm to investigate.

- The Firm also performed analytical procedures on the quarterly financial information and on cost of sales and operating expenses for the year. The procedures, however, were not adequate because the Firm's documented expectations were not precise enough to provide the desired level of assurance that differences that may be material misstatements would be identified for the Firm to investigate.

Issuer C

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to perform, or failed to include evidence in the work papers that it had performed, sufficient procedures to evaluate whether the issuer's accounting for the sale and servicing of loan participations complied with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Firm also failed to document the issuer's responsibilities, if any, for servicing the loan participations and the basis for the Firm's determination of the number of items (two) it tested.
- The Firm failed to perform sufficient tests of loan sales. It planned to employ a substantive audit approach, but it failed to perform, or failed to include evidence in the work papers that it had performed, detailed tests of the items on the client's summary spreadsheet of loan sales, and its primary audit procedures, which were analytical procedures, did not meet the requirements for substantive analytical procedures. In addition, the Firm identified errors relating to the completeness of the spreadsheet, but failed to resolve them, or failed to include evidence in the work papers that it had resolved them. Finally, the Firm failed to compare, or failed to

include evidence in the work papers that it had compared, the master sales agreements to the requirements of SFAS No. 140.

- The Firm used negative confirmations to test the existence of real estate and installment loans even though the combined level of inherent and control risk was not assessed as low. These loans represented approximately one-sixth of the total loan portfolio. PCAOB standards permit the use of negative confirmations to reduce audit risk to an acceptable level, but only when certain conditions are present, one of which is that the combined assessed level of inherent and control risk is low.
- Most of the issuer's investments, which represented approximately 18 percent of its total assets, were classified as available for sale and carried at fair market value. While the Firm recalculated the valuation of a sample of the non-marketable securities at an interim date, it failed to perform any roll-forward procedures between the interim date and year end. In addition, the Firm failed to test the valuation of the marketable securities, which represented the majority of the investment portfolio.
- The Firm used analytical procedures as the primary audit tests of investment income, fixed assets, other assets, interest and fee income, and interest expense. The analytical procedures, however, failed to meet, or the work papers failed to include evidence that they met, the requirements for substantive analytical procedures.
- The issuer primarily calculated its allowance for loan losses ("ALL") by applying certain reserve percentages, adjusted for qualitative considerations, to various identified risk-rated loan classifications and pools of loans. The Firm failed to perform, or failed to include evidence in the work papers that it had performed, either audit procedures to determine whether the reserve factors used to calculate the allowance were supportable or, in the alternative, audit procedures to develop an independent expectation regarding the ALL.

Issuer D

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm assessed inherent risk and control risk at the maximum and used a combination of a limited number (ten) of positive confirmations, analytical procedures and review of certain reconciliations to test the completeness assertion related to deposits. The Firm, however, failed to meet the requirements for substantive analytical procedures because the Firm failed to establish the auditor's expectations or the amount of the difference that could be accepted without further investigation.
- Mortgage loans represented approximately 85 percent of the issuer's total loan portfolio and consumer loans represented the remaining 15 percent. The Firm did not conclude that the combined level of inherent and control risk was low. To test existence of the loans, the Firm used negative confirmation requests for the consumer loans and a combination of positive confirmation requests (five percent of the confirmation requests) and negative confirmation requests (95 percent of the confirmation requests) for the mortgage loans. PCAOB standards permit the use of negative confirmations to reduce audit risk to an acceptable level, but only when certain conditions are present, one of which is that the combined assessed level of inherent and control risk is low.
- The issuer used a third-party service provider to process its loan and deposit transactions. The Firm used the service auditor's report to obtain its understanding of the service provider's internal control; however, the report did not cover the entire period subject to audit. The Firm failed to perform any procedures to update its understanding of the service provider's controls from the date of the service auditor's report through the issuer's year end.

Issuer E

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to perform sufficient tests of deposits, which represented approximately 85 percent of the issuer's liabilities. The Firm assessed control risk at the maximum and used a combination of seven positive confirmation requests, analytical procedures, and a reconciliation of the subsidiary ledger to the general ledger to test the completeness assertion related to deposits. The Firm failed to perform other procedures, such as testing the daily reconciliations, the daily proofs, access controls, dormant accounts, closed accounts, depositor account statements, and/or employee accounts.
- The Firm failed to perform sufficient tests of the issuer's allowance for loan losses, with respect to which the Firm assessed control risk and inherent risk at the maximum. The classification of loans within the loan categories (for example, substandard, delinquent, pass) serves as the issuer's basis for determining the allowance for loan losses. In order to test the classification of loans, the Firm examined a sample of only five loan files, only one of which was selected from the issuer's classified listing. In addition, the Firm reviewed the results of the issuer's third-party loan reviewer's tests; however, it did not rely on the reviewer's work.

Issuer F

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm assessed control risk at the maximum and used a combination of positive and negative confirmation requests and analytical procedures to test the completeness assertion related to deposits. The analytical procedures, however, failed to meet the requirements for substantive analytical procedures because the Firm failed to establish the auditor's expectations or the amount of the difference from any expectations that could be accepted without further investigation.
- The Firm used service auditors' reports for two third-party service providers in establishing its understanding of the service providers' controls over the loan and deposit processes and in its testing of controls over the loan processes. The service auditors' reports, however, did not

cover the entire period subject to audit, and the Firm failed to perform any procedures to update its understanding of the service providers' controls.

Issuer G

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The notes to the issuer's financial statements indicate that the issuer had only one reportable segment. The Firm failed to analyze whether this conclusion was appropriate under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Several factors suggest that the issuer may have had more than one reportable segment, including that the issuer had three operating divisions with separate general ledgers, that the issuer's chief executive and financial officers used information from those ledgers for assessing the divisions' performance and allocating resources to them, and the divisions had different gross margin percentages. In light of these factors, the Firm should have analyzed whether the issuer had more than one reportable segment under SFAS No. 131.
- The issuer used an outside service organization to process its payroll. The Firm failed to obtain the service auditor's report on the service organization's internal controls or to gain an understanding of the service organization's controls by other means. Thus, the Firm assessed control risk at the maximum for payroll expense. Nevertheless, the Firm failed to test the accuracy and completeness of the payroll reports from the service organization that the Firm used in its audit tests of payroll expense and related accounts. In addition, the Firm used analytical procedures in its tests of the payroll expense and related accounts. The procedures, however, did not meet the requirements for substantive analytical procedures because the Firm's documented expectations were not precise enough to provide the desired level of assurance that differences that may be material misstatements would be identified for the Firm to investigate.
- The Firm assessed control risk at the maximum and performed analytical procedures over income statement accounts; however, the Firm failed to

establish expectations that were precise enough to provide the desired level of assurance that differences that may be material misstatements would be identified for the Firm to investigate.

- When auditing the issuer's inventory reserves, the Firm failed to test the issuer-prepared reports that the Firm used, and it failed to evaluate, or failed to include sufficient evidence in the work papers that it had evaluated, the issuer's estimated realizable amounts or the issuer's ability to make those estimates.

Issuer H

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The issuer amortized certain deferred costs over the estimated useful lives of the related products. The Firm failed to test management's assertions regarding the estimated useful lives.
- The Firm used analytical procedures as the primary audit procedures for revenue, cost of goods sold and payroll. The procedures did not meet the requirements for substantive analytical procedures because the Firm failed to establish, or failed to include evidence in the work papers that it had established, expectations or the amounts of the differences from any expectations that could be accepted without further investigation. In addition, because the issuer had multiple product lines, the Firm should have disaggregated the data when performing the analytical procedures, but the Firm failed to do so.

Issuer I

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The engagement team used certain reports generated by the issuer's computer systems when testing inventory, revenue, accounts receivable and payroll. The Firm, however, failed to test the completeness and

accuracy of those reports even though the Firm had assessed control risk at the maximum. Thus, the Firm's reliance on the reports was not warranted.

- The Firm used analytical procedures as the primary audit procedures for sales and payroll and as a component of the audit procedures for inventory and accounts receivable. Inherent risk and control risk were assessed at the maximum for all audit areas. The Firm's analytical procedures did not meet the requirements for substantive analytical procedures because the Firm failed to establish, or failed to include evidence in the work papers that it had established, expectations or the amounts of the differences from any expectations that could be accepted without further investigation.

Issuer J

On this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm employed analytical procedures as its primary audit procedures for revenue and expense accounts. The procedures did not meet the requirements for substantive analytical procedures because the Firm failed to establish, or failed to include evidence in the work papers that it had established, expectations or the amounts of the differences from any expectations that could be accepted without further investigation.
- The issuer used a third-party service organization to process payroll. The Firm failed to gain an understanding of the service organization's controls, and it assessed control risk at the maximum for payroll expense. Nevertheless, the Firm failed to test the accuracy and completeness of the payroll reports from the service organization that the Firm used in its audit tests of payroll expense and related accounts.

Issuer K

On this audit, the Firm assessed control risk at the maximum and performed analytical procedures to test payroll expense. However, the procedures did not meet

the requirements for substantive analytical procedures because the Firm failed to establish, or failed to include evidence in the work papers that it had established, expectations or the amount of the difference from any expectations that could be accepted without further investigation.

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following six functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, promotion, assignment of responsibilities and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances and arrangements; commissions and contingent fees; and the alternative practice structure; (4) client acceptance and retention; (5) the Firm's internal inspection program; and (6) practices for establishment and communication of audit policies, procedures and methodologies, including training. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

PART II, PART III, AND APPENDIX A OF THIS REPORT ARE NONPUBLIC
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX B

THE INSPECTION PROCESS

The inspection process was designed and performed to provide a basis for assessing the degree of compliance of McGladrey with applicable requirements and standards related to auditing issuers. This process included reviews of components of selected issuer audit engagements completed by McGladrey. These reviews were intended both to identify deficiencies, if any, in the conduct of those audits and to determine whether the results of those audits indicated deficiencies in the design or operation of the Firm's system of quality controls over audits. In addition, the inspection included reviews of the design and, in some cases, the application of procedures related to certain functional areas of McGladrey that could be expected to influence audit quality.

1. Review of Selected Audit Engagements

The inspection team reviewed aspects of selected audits performed by McGladrey. The inspection team chose the engagements according to the Board's criteria. McGladrey was not allowed an opportunity to limit or influence the engagement selection process or any other aspect of the review.

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenues, reserves or estimated liabilities, debt and debt covenants, going concern analyses, deposit liabilities, loans and allowances for loan losses, inventories, long-lived assets, execution of fraud procedures, income taxes, assessment of risk by the audit team, and testing and documentation of internal controls by the audit team. The inspection team also analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. With respect to certain engagements, the inspection team reviewed written communications between McGladrey and the issuer's audit committee and also interviewed the chairperson of the issuer's audit committee.

When the inspection team identified a potential issue, it discussed the issue with members of the audit engagement team. If the inspection team was unable to resolve

the issue through this discussion and any review of additional work papers or other documentation, the inspection team ordinarily requested the engagement team to consult with McGladrey's National Office of Audit & Accounting.

2. Review of Six Functional Areas

The inspection team conducted the procedures related to the review of six functional areas primarily at McGladrey's National Office. With respect to five of the functional areas, the inspection team also conducted procedures at certain of McGladrey's practice offices. The review of the six functional areas was designed to provide a knowledge base on which to draw in planning future inspections, comparing firm practices, and measuring progress over time. The inspection team also performed procedures to identify possible defects in McGladrey's system of quality controls. A more detailed description of the scope with respect to each of the six functional areas follows.

As reflected in the descriptions that follow, the inspection team's procedures took account of the fact that McGladrey is part of an APS with H&R Block, Inc. ("H&R Block"). H&R Block, through its wholly-owned subsidiary, RSM McGladrey Business Services, Inc., owns the non-attest businesses and assets of many certified public accounting firms, including RSM McGladrey, Inc. ("RSMI"). RSMI performs accounting, tax and consulting services for corporate clients. McGladrey performs audits and other attest services. H&R Block does not have an ownership interest in McGladrey; however, RSMI provides working capital financing to McGladrey under a loan agreement, and the partners of McGladrey are employed as managing directors of RSMI. In addition, through an administrative services agreement, RSMI provides accounting, payroll, human resources, and other services to McGladrey and receives a management fee for these services.

As a consequence, the inspection procedures included interviews with certain personnel of RSMI and RSM McGladrey Business Services, Inc. The inspection team also performed interviews at H&R Block's national headquarters and interviewed, by telephone, certain members of the management of other H&R Block subsidiaries.

a. Review of Partner Evaluation, Compensation, Promotion, Assignment of Responsibilities and Disciplinary Actions

The inspection team evaluated McGladrey's policies and procedures related to partner evaluation; partner compensation; nomination and admission of new partners; and discipline, assignment of duties and termination of partners. The inspection procedures were designed to provide a basis for an assessment of whether the design of these processes, as documented and communicated, could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm.

The inspection team interviewed 16 members of McGladrey's and RSML's leadership teams at McGladrey's National Office, as well as members of leadership and audit partners in practice offices, regarding these topics. In addition, the inspection team analyzed schedules provided by McGladrey that detailed information on each partner, including the partner's location, recent evaluation history, and compensation history. The inspection team also reviewed a sample of partners' personnel files, including files of newly admitted partners, partners who resigned or took early retirement, and partners who received bonus compensation.

b. Review of Independence Policies and the Alternative Practice Structure

The objectives of the inspection procedures in this area included gaining an understanding of and evaluating McGladrey's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer clients; the Firm's participation in the APS, business ventures, alliances, and arrangements; contingent fee arrangements; and the provision of services pursuant to Section 404 of the Act. To accomplish these objectives, the inspection team reviewed the Firm's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed McGladrey's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures; examined McGladrey's independence consultation process, which included reviewing a sample of independence consultations; and reviewed information concerning the Firm's existing business ventures, alliances and arrangements, as well as McGladrey's process for establishing such enterprises. The inspection team also interviewed numerous National Office and

practice office personnel regarding the Firm's independence policies, practices and procedures.

For certain of the engagements selected for review, the inspection team reviewed relevant information to identify any non-audit services performed for the issuer, including whether any of the services involved contingent fee arrangements; to determine whether the Firm was involved in any business ventures, alliances, or arrangements with the issuer; and to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement. In addition, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

The objectives of the inspection procedures in this area included gaining an understanding of McGladrey's APS relationship with H&R Block and certain of its subsidiaries. The inspection team focused on independence issues related to the provision of non-audit services to issuer clients, whether the personnel of H&R Block and its subsidiaries were familiar with the applicable policies and procedures regarding independence, integrity and objectivity, and whether H&R Block has implemented an appropriate system of quality controls to ensure compliance with such policies and procedures. The inspection team reviewed, analyzed and evaluated McGladrey's and RSML's policies, procedures, and guidance materials related to independence (including independence consultations) for non-audit services to audit clients; their training programs on independence; and their procedures for independence consultations, which included reviewing the results of a sample of independence inquiries.

In addition, the inspection team interviewed the Chief Executive Officer/Chairman of the Board, the Chief Operating Officer and the Chief Financial Officer of H&R Block; the President of RSM McGladrey Business Services, Inc./RSML; the Senior Vice President Economic Unit Operations/COO of RSML and seven other officers of certain H&R Block subsidiaries.

c. Review of Client Acceptance and Retention Policies

The primary objectives of the inspection procedures in this area were to evaluate whether McGladrey's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and

that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed McGladrey's policies and procedures for acceptance and continuance of public audit clients and non-public companies likely to go public within two years; evaluated documentation related to new clients, retained clients, and clients that had recently changed to other auditors from McGladrey; and interviewed members of McGladrey's leadership.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, evaluated whether the client continuance documentation was completed and approved in accordance with McGladrey's policies; interviewed the audit partners and managers on these engagements concerning the reasons for continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks; and assessed whether the audit planning documentation incorporated the specific actions, if any, developed in response to any identified risks.

d. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of McGladrey's annual internal inspection program in enhancing audit quality, as well as to assess the Firm's compliance with the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance and forms at McGladrey's National Office related to its internal inspection program, documentation of the results of the current year's inspection program, and steps taken by McGladrey in response to those results. The inspection team also interviewed McGladrey's leadership concerning the process and effectiveness of its internal inspection program.

The inspection team reviewed and tested the conduct of the internal inspection program in two practice offices where McGladrey had conducted internal inspections. These procedures included evaluating the qualifications of McGladrey's inspectors, reading the inspectors' comments, reviewing the results of the inspectors' review of certain Firm-wide functional areas, and interviewing both office leadership and selected audit personnel concerning the internal inspection program. In addition, for a sample of the engagements that the internal inspectors had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with

McGladrey any significant differences in the results of the inspection team's review and that of McGladrey's internal inspectors.

e. Review of Practices for Establishment and Communication of Audit Policies, Procedures and Methodologies, Including Training

The objectives of the inspection team's procedures in this area were to obtain an understanding of McGladrey's processes for establishing and communicating audit policies, procedures and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; and to evaluate the changes in audit policies that McGladrey had made during the period under inspection.

Toward those objectives, the inspection team reviewed documentation relating to McGladrey's methods for developing policies and procedures, as well as internal guidance and/or training materials distributed to audit personnel with respect to recent changes in requirements and to selected specific areas. The inspection team also evaluated the effectiveness of the design of McGladrey's processes for monitoring developments that could affect McGladrey's audit policies, procedures and methodologies.

f. Review of Tone at the Top

The primary objective of the review of the Firm's "tone at the top" was to assess whether actions by and communications from the Firm's leadership, as well as relevant actions by and communications from H&R Block and RSML, demonstrate a commitment to audit quality and compliance with the Act, the rules of the Board, the rules of the SEC, and PCAOB standards in connection with McGladrey's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at McGladrey's National Office. Such information included McGladrey's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, the Firm's staff and leadership; public company audit proposals; internal and external communications from management; descriptions of McGladrey's financial structure and business plan; and agendas and minutes of McGladrey's governing board. In addition, the inspection team interviewed 16 members of McGladrey's and RSML's leadership teams, as well as 10 members of senior management of McGladrey's APS affiliates.

The inspection team conducted interviews at four practice offices to obtain perspectives on communications from the Firm's, H&R Block's, and RSML's leaderships relating to audit quality and tone at the top. The inspection team interviewed members of the leadership at certain of these offices, including EU^{9/} and office audit leadership, EU audit and accounting specialists, and office managing partners, as well as certain audit partners assigned to engagements that were reviewed. In addition, the inspection team conducted focus group meetings in two offices to assess the participants' understanding of, among other things, the messages conveyed by the National Office, practice office leadership and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top. One of these focus group meetings consisted of audit senior managers and audit managers, and the other consisted of audit senior accountants and audit staff.

^{9/} The Firm is organized by geographic regions, called Economic Units ("EU"), that the Firm and RSML use for managing the business.

APPENDIX C

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements, in the draft, that the Board corrects in the final report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.

McGladrey & Pullen

Certified Public Accountants

November 18, 2005

Mr. George H. Diacont
Director
Division of Registration and Inspection
Public Company Accounting Oversight Board
1666 K Street, N. W.
Washington DC 20006

Re: Response to the Public Company Accounting Oversight Board (PCAOB) Report of 2004 Inspection of McGladrey & Pullen, LLP

Dear Mr. Diacont:

Thank you for the opportunity to submit our response to the PCAOB's October 18, 2005 draft of its Report of Inspection of McGladrey & Pullen, LLP. We support the PCAOB's inspection process and believe that inspection comments and observations will help us enhance the quality of audit engagements.

We have taken appropriate actions to address the deficiencies identified by the PCAOB's inspection team, including, in certain instances, performing additional procedures in accordance with AU 390, *Consideration of Omitted Procedures after the Report Date* and, in other instances, adding currently dated documentation to our workpapers to more completely and accurately describe the procedures performed, evidence obtained and conclusions reached. We note that, in no instances, did reported net income or stockholders' equity change as a result of the inspection findings. We have also enhanced our firm's training programs and practice aids to address the PCAOB's findings and have increased our monitoring activities through additional inspections.

Certain findings relate to the requirements to establish and document expectations for substantive analytical procedures. Although we do not take exception to these findings, we believe our overall performance of analytical procedures was effective.

McGladrey & Pullen, LLP is committed to working with the PCAOB staff to improve our system of quality controls. We have a long history of audit quality founded on our commitment to integrity, objectivity and excellence.

Please contact Leroy Dennis at (952) 921-7627 with any questions regarding this letter.

Sincerely,



McGladrey & Pullen, LLP is a member firm of RSM International,
an affiliation of separate and independent legal entities.