

# **The School Board of Miami-Dade County, Florida**

## **Audit Plan and SAS 114 Communication**

For the fiscal year ending June 30, 2015

May 12, 2015



Assurance • Tax • Consulting

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# Executive Summary

This document outlines the audit planning process and communicates to The School Board of Miami-Dade County, Florida (the “School Board”) Audit and Budget Advisory Committee, the Superintendent, management, and members of the engagement team, the aspects of our preliminary approach and scope of services to be provided in conducting the audit of the basic financial statements of the School Board, as of and for the year ending June 30, 2015.

# Communication

Effective communication between our Firm, the Superintendent, the Audit and Budget Advisory Committee, and the School Board members, is important to understanding matters related to the audit and in developing a constructive working relationship.

Your insights may assist us in understanding the School Board and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events. We will discuss with you your oversight of the effectiveness of internal control and any areas where you request additional procedures to be undertaken. We expect that you will timely communicate with us any matters you consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures, your suspicion or detection of fraud or abuse, or any concerns you may have about the integrity or competence of management.

# Auditor's Communication Responsibility

We will timely communicate to you any fraud involving management and other fraud that causes a material misstatement of the financial statements, illegal acts, instances of noncompliance, or abuse that come to our attention (unless they are clearly inconsequential) and any disagreements with management and other serious difficulties encountered in performing the audit. We will also communicate to you and to management any significant deficiencies or material weaknesses in internal control that become known to us during the course of the audit. Other matters arising from the audit that are, in our professional judgment, significant and relevant to you in your oversight of the financial reporting process will be communicated to you in writing after the audit.

# Additional Required Communications with the Audit and Budget Advisory Committee and Superintendent

**Statement of Auditing Standard (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance*, require the auditor to provide certain information regarding the conduct of the audit to those who have responsibility for oversight of the financial reporting process. At the completion of the audit, the following matters will be communicated:**

- Significant findings resulting from the audit
- The auditor's views about qualitative aspects of the School Board's significant accounting practices including accounting policies, accounting estimates, and financial statement disclosures
- Significant difficulties, if any, encountered during the audit
- Uncorrected misstatements with management, other than those the auditor believe are not material
- Disagreements with management, if any
- Material misstatements that were brought to the attention of management as a result of audit procedures and corrected
- Management's consultations with other accountants
- Significant issues, if any, arising from the audit that were discussed, or the subject of correspondence with management
- Management's Representation Letter

# Independence

Our independence policies and procedures are designed to provide reasonable assurance that our firm and its personnel comply with applicable professional independence standards. Our policies address financial interest, business and family relationships, and non-audit services that may be thought to bear on our independence. For example:

- Partners and professional employees of McGladrey LLP are restricted in their ability to own a direct financial interest or a material indirect financial interest in a client or any affiliates of a client.
- If an immediate family member or close relative of a partner or professional employee is employed by a client in a key position, the incident must be reported and resolved in accordance with Firm policy.

In addition, our policies restrict certain non-audit services that may be provided by McGladrey LLP, and require audit clients to accept certain responsibilities in connection with the provision of permitted non-attest services.

# The Concept of Materiality in Planning and Executing the Audit

We apply the concept of materiality both in planning and performing the audit, evaluating the effect of identified misstatements on the audit, and the effect of uncorrected misstatements, if any, on the financial statements, and in forming the opinion in our report.

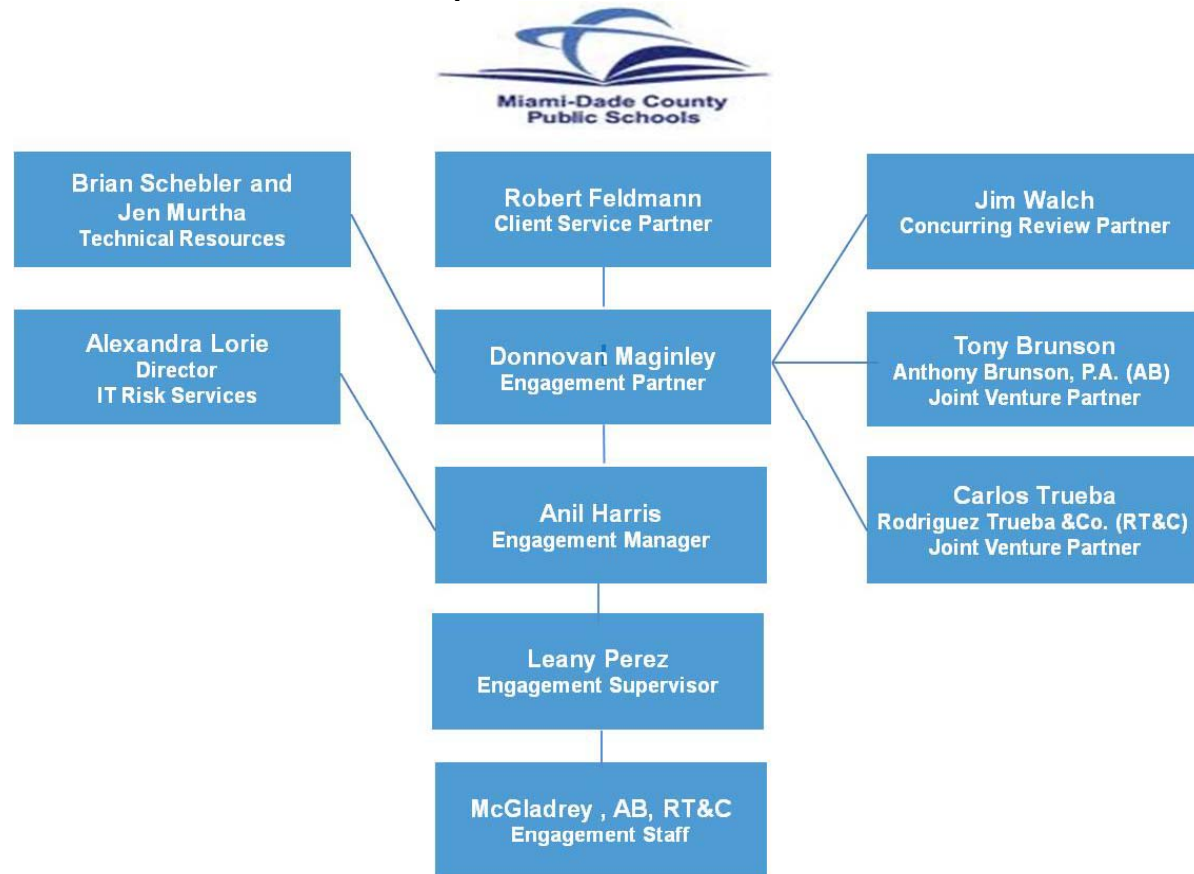
Our determination of materiality is a matter of professional judgment and is affected by our perception of the financial information needs of users of the financial statements. We establish performance materiality at an amount less than materiality for the financial statements as a whole to allow for the risk of misstatements that may not be detected by the audit. We use performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

Our assessment of materiality throughout the audit will be based on both quantitative and qualitative considerations. Because of the interaction of quantitative and qualitative considerations, misstatements of a relatively small amount could have a material effect on the current financial statements as well as financial statements of future periods. We will accumulate misstatements identified during the audit, other than those that are clearly immaterial. At the end of the audit, we will inform you of all individual unrecorded misstatements aggregated by us in connection with our evaluation of our audit test results.



# Audit Team

The following is our organizational chart presenting all key personnel, including their titles and functions to be performed on this audit.



# Basic Users

The audit is intended to serve the basic users as follows:

Users	Auditor
Citizens, Taxpayers, Bondholders, Federal and State Agencies	Issue an Independent Auditor's Opinion and other reports that provide reasonable assurance that the School Board's basic financial statement is fairly stated.
School Board Members and the Audit and Budget Advisory Committee	Assists the School Board members and the Audit and Budget Advisory Committee, through our work and reports, in discharging it's corporate governance and compliance responsibilities.
Superintendent and Management	Provide observations and advice on financial reporting, accounting, and internal control and compliance matters. Share ideas and "best practices" from our experience.

# Auditor's Responsibility Under *Government Auditing Standards* and Auditing Standards Generally Accepted in the United States of America

The primary objective of our audit is to express an opinion on the fair presentation of the basic financial statements of the School Board, in accordance with accounting principles generally accepted in the United States of America.

We have a responsibility to conduct our audit in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Furthermore, the audit will meet the requirements of *Florida Statutes*, *Rules of the Florida Auditor General*, and the *U.S Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*.

In carrying out this responsibility, we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute assurance that material misstatements are detected. We have no responsibility to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected.

# Management's Responsibilities

**As part of the audit process, management is responsible for the following:**

- The preparation of the School Board's basic financial statements;
- Establishing and maintaining effective internal control over financial reporting and compliance;
- Identifying and ensuring that the School Board complies with the laws and regulations applicable to its activities;
- Making all financial records and related information available to the auditor;
- Providing assistance to the auditor in connection with the audit process;
- Providing the auditor with a letter that confirms certain representations made during the audit;
- Adjusting the basic financial statements to correct material misstatements and affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the basic financial statements taken as whole; and
- Maintaining compliance with the provisions of grant agreements and other relevant contracts.

# Deliverables

## **Planned deliverables to the School Board:**

- Independent auditor's report on the School Board's basic financial statements;
- Management's representation letter;
- Management letter in accordance with the rules of the Auditor General of the State of Florida;
- Attestation report on compliance with Section 218.415, Florida Statutes;
- Single Audit Reports; and
- Audit and Budget Advisory Committee communication letter.

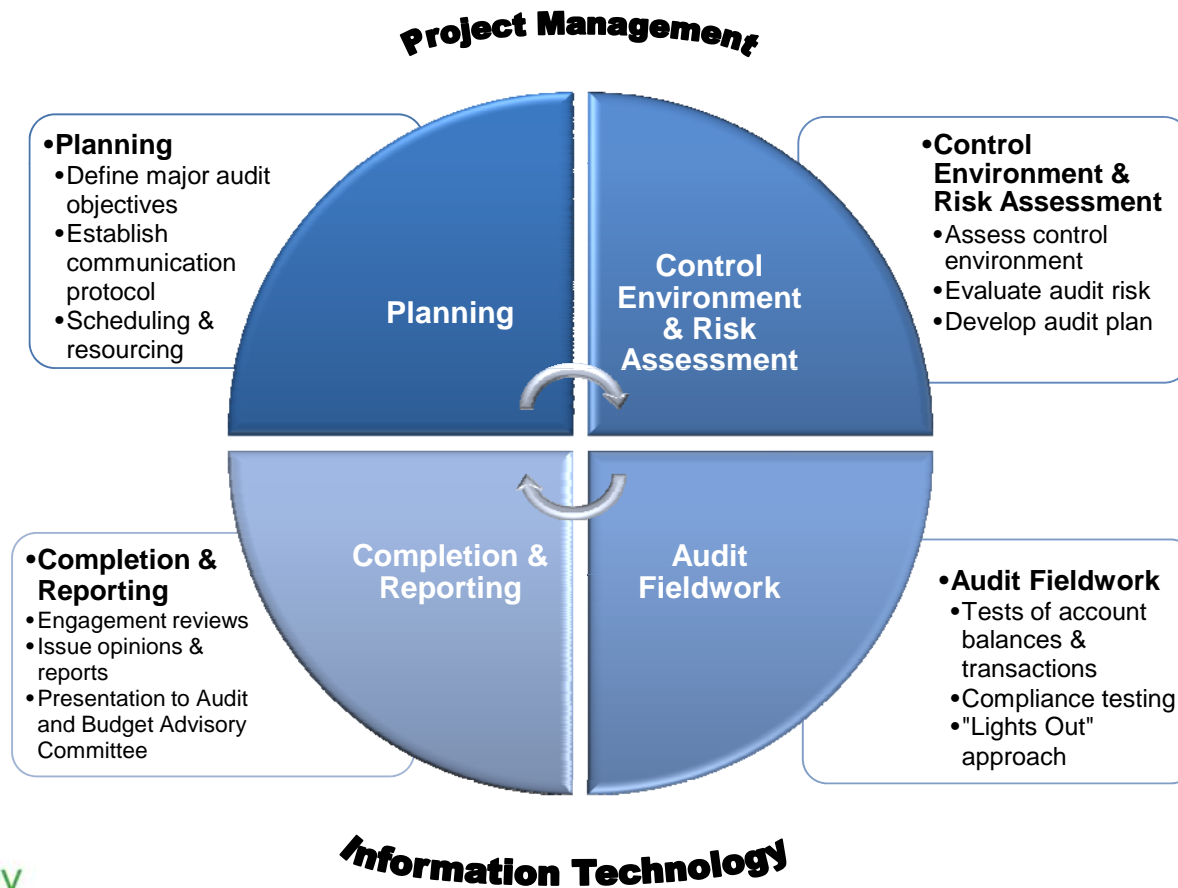
# Engagement Timetable

The following chart depicts our proposed audit timeline for fiscal year 2015 which may be modified based on discussion with School Board staff during our audit planning meetings.

Audit Stage	May	June	Sept	Oct	Nov	Dec
Planning Phase:						
Present detailed audit plan to the Audit and Budget Advisory Committee	■					
Attend monthly Audit and Budget Advisory Committee meetings	■	■	■			■
Interim work		■				
Fieldwork Phase:						
Complete fieldwork			■	■	■	
Perform bi-weekly status meetings			■	■	■	
Reporting Phase:						
Exit conference					■	
Final reports					■	
Presentation to The School Board Members and the Audit and Budget Advisory Committee:						
Financial Statements						■
Management Letter and Single Audit Reports						■

# Key Elements in Our Audit Methodology

The following diagram depicts an overview of our audit approach. Embedded within the approach is our overall project management as well as our utilization of information technology and computer-assisted audit techniques:



# Audit Approach

## Preliminary Phase

### **Planning Activities and Risk Assessment:**

- Review interim financial information and prior year financial statements to identify accounting issues, if any;
- Review Board and Audit and Budget Advisory Committee minutes;
- Obtain copies of all new significant agreements, contracts, and pertinent documents, and evaluate the effects of new contracts on the scope of the audit;
- Review prior year compliance reports and management letter and obtain status updates from management;
- Highlight accounting and reporting matters and refine our understanding of audit risks;
- Meet with finance department personnel to coordinate schedules to be prepared; and
- Attend the School Board Audit and Budget Advisory Committee meetings to identify areas of concern and emphasis, fraud risk areas, new developments, planned operations, and strategic changes.



# Audit Approach (continued)

## Preliminary Phase (continued)

### **Planning Activities and Risk Assessment:**

- Identify critical audit objectives;
- Obtain an understanding and document internal accounting control systems in place;
- Assess materiality considerations;
- Perform compliance tests of internal controls where appropriate;
- Identify substantive procedures to be performed;
- Coordinate IT audit testing of system files;
- Perform interim review of significant audit areas;
- Discuss interim findings and changes to our audit plan with management;
- Evaluate management's basis for developing estimates for reasonableness and consistency.

# Audit Approach (continued)

## Final Fieldwork and Reporting Phase

### **Fieldwork and Reporting:**

- Confirm account balances
- Test account reconciliations
- Perform test of details
- Vouch significant transactions
- Perform substantive analytical procedures
- Evaluate third-party service organization reports
- Test and evaluate key estimates and management's key assumptions
- Perform compliance testing
- Draft independent auditor's report (CAFR)
- Draft single audit reports
- Draft management letter

# Areas of Emphasis

## Internal Controls

- Obtain and document our understanding of controls over key processes (cash receipts & disbursements, payroll, self-insurance, grant/program management, etc.)
- Document and determine testing procedures of IT general controls
- Review reports issued by the Office of Management and Compliance Audits

## Estimates

- Budgets
- Self-insurance claims liability
- Compensated absences
- Litigation and other contingencies
- Retirement and other employee benefits (GASB No. 68 adoption)

## Routine Processes / Transactions

- Cash receipts and disbursements
- Revenues
- Payroll
- Purchases and accounts payables
- Property & equipment management
- Grant administration and compliance

## Non-Routine Processes / Transactions

- Debt issuance and compliance with covenants
- Investments (portfolio management)
- Significant and unusual contracts
- Interlocal agreements

# Significant Accounting Areas

Accounting Area	Risk	Audit Procedures
Self-insurance Claims Liability (\$179.1M*)	<ul style="list-style-type: none"> <li>The School Board's self-insurance liability for general liability, employee health, workers' compensation, and general property and casualty is misstated</li> <li>Sufficient resources not available to satisfy outstanding claims</li> <li>Exposure to risk is not reflected in accrual estimate</li> </ul>	<ul style="list-style-type: none"> <li>Review agreements and School Board Policy to ensure proper accrual</li> <li>Perform competence assessment of actuary</li> <li>Assess the propriety and completeness of data sent to actuary</li> <li>Evaluate actuarial reports and reasonableness of assumptions utilized</li> <li>Evaluate the amounts recorded compared to actuary's computation/estimates</li> </ul>
Revenue (Taxes, Intergovernmental, etc.) (\$3.5B*)	<ul style="list-style-type: none"> <li>Revenue is recognized improperly</li> <li>Unavailable/unearned revenue misstated</li> </ul>	<ul style="list-style-type: none"> <li>Obtain an understanding of the School Board's revenue recognition policy and assess its compliance with GAAP</li> <li>Perform subsequent receipts/cut-off testing</li> <li>Confirm significant revenue balances</li> </ul>
Capital Assets and Construction Activity (\$4.5B*)	<ul style="list-style-type: none"> <li>Capital asset purchases not being capitalized</li> <li>Completed construction projects not being transferred to depreciable asset categories</li> <li>Impairment of capital assets not identified/ reported</li> <li>Depreciation not properly determined</li> </ul>	<ul style="list-style-type: none"> <li>Test additions to capital assets</li> <li>Test depreciation expense</li> <li>Test completed projects and transfers</li> <li>Assess the applicability of GASB 51 - Accounting and Financial Reporting for Intangible Assets</li> </ul>

\* Prior year reported amounts



# Significant Accounting Areas (continued)

Accounting Area	Risk	Audit Procedures
Accounting for Retirement & Other Employee Benefits (19.9M*)	<ul style="list-style-type: none"> <li>Amounts not properly estimated and recorded based on terms of agreements and School Board Policy</li> </ul>	<ul style="list-style-type: none"> <li>Perform competence assessment of actuary</li> <li>Assess the propriety and completeness of data sent to and utilized by the actuary</li> <li>Evaluate actuarial reports and reasonableness of assumptions utilized</li> <li>Evaluate the amounts recorded compared to actuary's computation/estimates</li> <li>Assess the completeness and accuracy of employee information provided for the Florida Retirement System (FRS)</li> <li>Perform due diligence procedures pertaining to the allocation of pension liability from FRS.</li> </ul>
<p>Implementation of New Applicable Governmental Accounting Standards Board (GASB) Statements:</p> <p><i>GASB Statement No. 68, Accounting and Financial Reporting for Pensions (an amendment of GASB Statement No. 27)</i></p>	<ul style="list-style-type: none"> <li>Improper application and/or implementation of applicable GASB statements</li> <li>Improper Financial Reporting of Pension Plans</li> </ul>	<ul style="list-style-type: none"> <li>Assess the valuation of the recognized long-term obligation for pension benefits and annual costs of pension benefits.</li> <li>Assess the propriety of Financial Statement reporting of pension plans as it relates to new note disclosures and required supplementary information in accordance in GASB 68.</li> </ul>

\* Prior year reported amounts



# Significant Accounting Areas (continued)

Accounting Area	Risk	Audit Procedures
Interfund Transfers (\$355.8M*)	<ul style="list-style-type: none"> <li>Noncompliance with applicable laws, agreements, and School Board policy</li> </ul>	<ul style="list-style-type: none"> <li>Test transfers to ensure compliance with applicable laws, agreements and School Board Policy</li> <li>Agree interfund transfers to annual adopted School Board budget</li> </ul>
Fund Balance Accounting and GASB 54 - <i>Fund Balance Reporting and Governmental Fund Type Definitions</i> (\$476.1M*)	<ul style="list-style-type: none"> <li>Equity transactions are not properly classified and/or presented in the appropriate categories</li> <li>Fund Balance policies and procedures are not properly defined</li> </ul>	<ul style="list-style-type: none"> <li>Review minutes, statutes, debt indentures, and grant contracts to ascertain proper fund balance classification and reporting</li> <li>Review appropriate documentation to support fund balance designations</li> <li>Inquiry about the existence of restrictions and designations and ensure proper disclosure of such amounts</li> </ul>
Cash and Investments (\$595.2M*)	<ul style="list-style-type: none"> <li>Investments are not properly valued</li> <li>Investments and related income, gains and losses are not reported in the appropriate net position class</li> <li>Non-marketable investments lack adequate support for the valuation</li> <li>Investments purchased/held not in compliance with School Board Policy</li> </ul>	<ul style="list-style-type: none"> <li>Perform test of internal control over treasury functions</li> <li>Test management's compliance with the School Board's investment policy</li> <li>Test investment valuations and review management's fair value assessment of those securities whose fair value is not readily determinable</li> <li>Confirm significant cash and investment balances</li> </ul>

\* Prior year reported amounts



# Significant Accounting Areas (continued)

Accounting Area	Risk	Audit Procedures
Liabilities and Expenditures (\$4.1B* and \$3.6B*, respectively*)	<ul style="list-style-type: none"> <li>Liabilities and expenditures not reported in the proper period</li> <li>Possible budget violations</li> </ul>	<ul style="list-style-type: none"> <li>Determine if there are any items in dispute at year end</li> <li>Review disbursements occurring subsequent to year end to test for unrecorded liabilities</li> <li>Obtain an explanation for significant variances in account balances occurring between fiscal years</li> </ul>
Payroll (\$1.8B*)	<ul style="list-style-type: none"> <li>Improper payments to employees</li> <li>Liabilities and expenditures not reported in the proper period</li> </ul>	<ul style="list-style-type: none"> <li>Perform internal control testing to assess whether there is proper supervisory review and approval of payroll transactions</li> <li>Test the accuracy and completeness of current year payroll balances</li> </ul>

\* Prior year reported amounts



# Significant Accounting Areas (continued)

Accounting Area	Risk	Audit Procedures
Accounting for Derivative Instruments and Hedge Activities (\$27.5M*)	<ul style="list-style-type: none"> <li>▪ Improper accounting/valuation of derivative instruments/transactions</li> <li>▪ Improper financial statement presentation of derivative instruments/transactions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assess the accounting of derivative instruments and hedging activities</li> <li>▪ Review agreements and assess the propriety of financial statement disclosures</li> <li>▪ Evaluate specialists reports and reasonableness of assumptions utilized in valuing the instrument</li> <li>▪ Perform competence assessment of specialists used</li> <li>▪ Evaluate the effectiveness of the hedging instrument</li> </ul>
Compliance with Bond Agreements (\$3.3B*)	<ul style="list-style-type: none"> <li>▪ Non-compliance with applicable bond agreement covenants</li> <li>▪ Bond proceeds used for unallowed activity or costs</li> </ul>	<ul style="list-style-type: none"> <li>▪ Review bond agreement and test the School Board's compliances with applicable requirements/covenants</li> <li>▪ Test expenditures funded with bond proceeds for compliance with bond agreements</li> </ul>
Full Time Equivalent Determinations (FTE)	<ul style="list-style-type: none"> <li>▪ Amounts are not determined in accordance with Florida Department of Education Guidelines</li> </ul>	<ul style="list-style-type: none"> <li>▪ Auditor General's most recent Review reports issued by the Office of Management and Compliance Audits regarding FTE audits</li> <li>▪ Review FTE Report</li> </ul>

\* Prior year reported amounts



# Significant Accounting Areas (continued)

Accounting Area	Risk	Audit Procedures
Results from Operations / Going Concern	<ul style="list-style-type: none"> <li>Revenue does not equal or exceed expenditure</li> <li>Deteriorating financial condition</li> </ul>	<ul style="list-style-type: none"> <li>Perform Financial Condition Assessment</li> <li>Review budget to actual statements</li> </ul>
IT Systems	<ul style="list-style-type: none"> <li>Unauthorized access – both from internal and external users</li> <li>Improper management of user access rights (assignment/monitoring)</li> <li>Improper use of portable devices to access the School Board's systems</li> <li>Improper change management system</li> <li>Program applications are not functioning as designed</li> </ul>	<ul style="list-style-type: none"> <li>Test access controls</li> <li>Test change management system controls</li> <li>Test validity of program logic and configuration</li> <li>Test various interface systems and the financial reporting package</li> <li>Meet with IT Managers to discuss the impact of systems on financial reporting</li> <li>Project plan review</li> <li>System development life cycle assessment</li> <li>Test Payroll Certification Application</li> </ul>

# Fraud Considerations and Risk of Management Override

We are responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of misstatement, whether caused by error or fraud (*SAS No. 99, Consideration of Fraud in a Financial Statement Audit*).

Our audit procedures will encompass requirements of SAS No. 99 which includes:

- Brainstorming among engagement team to identify fraud risk areas;
- Gathering information to facilitate the identification of and responses to fraud risk;
- Perform computer assisted testing of journal entries to identify significant and/or unusual transactions;
- Perform walkthroughs and test of controls to address the risk of management override of controls;
- Inquiry of various members of management and the Audit and Budget Advisory Committee their assessment of audit and fraud risk factors.

# McGladrey Peer Review Report

Government auditing standards requires audit organizations to have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every three years.

McGladrey LLP's system of quality control for the accounting and auditing practice applicable to non-SEC issuers in effect for the year ended April 30, 2013, was subject to peer review by the firm of BKD, LLP. Under the peer review standards, firms can receive a rating of pass, pass with deficiency(ies), or fail. McGladrey LLP received a peer review rating of pass. BKD, LLP's report is included on the following slide for your review.

# McGladrey Peer Review Report (continued)



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## System Review Report

To the Partners of  
McGladrey LLP  
and the National Peer Review Committee  
of the American Institute of Certified  
Public Accountants Peer Review Board

We have reviewed the system of quality control for the accounting and auditing practice of McGladrey LLP (the "firm") applicable to non-SEC issuers in effect for the year ended April 30, 2013. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included engagements performed under *Government Auditing Standards*, audits of employee benefit plans, audits performed under FDICIA, and audits of carrying broker-dealers, and examinations of service organizations [Service Organizations Control (SOC) 1 and 2 engagements].

In our opinion, the system of quality control for the accounting and auditing practice of McGladrey LLP applicable to non-SEC issuers in effect for the year ended April 30, 2013, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. McGladrey LLP has received a peer review rating of *pass*.

*BKD, LLP*

December 4, 2013



# Our Commitment to Audit Quality and Professional Excellence

In September 2014, McGladrey published a report titled ***Our Commitment to Audit Quality and Professional Excellence***. This report provides information on firm matters directly related to audit quality, such as governance, leadership, independence, audit performance and monitoring. All of these matters are critical to inspiring investor, lender and financial statement user confidence through the integrity, competence, objectivity and independence of our work and profession. As a firm, we are committed to these principles and believe our reputation for audit quality is our most valuable asset, and protecting that reputation is our highest priority.

We believe that this report, which is attached as Appendix A, will be of interest to you in your governance role as a member of the Audit and Budget Advisory Committee.

# Open Discussion



# OUR COMMITMENT TO AUDIT QUALITY AND PROFESSIONAL EXCELLENCE

September 2014



Assurance ■ Tax ■ Consulting



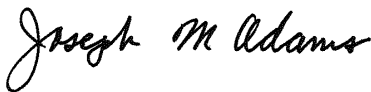
McGladrey has had a commitment to audit quality and professional excellence for more than 85 years. The quality of an audit that inspires investor confidence is built on the integrity, competence, objectivity and independence of our profession.

A number of important components impact the quality of an audit, and no single factor can, by itself, define audit quality. However, our system of quality control is intended to address key elements, such as leadership, adherence to relevant ethical requirements, acceptance and continuance of client engagements, personnel management, engagement performance and monitoring.

Each of these elements has one common and important thread – our people. Ultimately, audit quality is determined by an organization’s people – by what they do and by what they say. Competent individuals who are committed to the principles of integrity, objectivity and independence are at the very core of audit quality.

McGladrey, our partners and our other professionals are committed to these principles, and we align our firm’s values and infrastructure accordingly. We strive for continuous improvement by constantly examining what we do and how we do it to determine ways to improve the quality and effectiveness of our work.

This report provides information for our clients and others on matters directly related to audit quality, such as governance, leadership, independence, audit performance and monitoring. It also includes summaries of certain actions we have undertaken and plan to take to improve our system of quality control. We hope this report gives you a glimpse of our commitment to providing audit quality for our clients.



Joseph M. Adams  
Managing Partner and CEO



Jim Morton  
National Assurance Leader



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## A strong foundation for quality

### Organizational structure

Founded by Ira B. McGladrey in 1926, McGladrey LLP ranks as the fifth largest provider of both assurance services (audits, reviews, compilations and other assurance services) and nonassurance services (tax and consulting services) (source: *Accounting Today*). Our firm employs approximately 7,300 people in more than 70 offices across the United States.

Like most major U.S. accounting firms, our firm is structured as a limited liability partnership, based on the principle that the auditing professional must be in control of, and financially at risk for, the services provided. McGladrey and its individually licensed certified public accountants (CPAs) are regulated by a number of state and federal requirements. All CPAs must be licensed in the state in which their office is located.

<i>Personnel-related information – as of April 30, 2014</i>		
	<b>All personnel</b>	<b>Assurance services personnel</b>
Partners/principals	676	314
Directors/managers	1,870	610
Professional staff	3,178	1,550
Total professionals	5,724	2,474
Certified public accountants	2,669	1,254
Total personnel	7,269	

### Firm governance

McGladrey's partnership agreement provides the foundation for its governance, including the requirement for a managing partner. At a minimum, the McGladrey board consists of the managing partner and 11 additional partners/principals. The majority of board members must be partners.

The term of each board member is four years, and vacancies are filled by written ballot. The board of directors has sole and exclusive responsibility for all decisions affecting McGladrey, including the following:

- Oversight of the partnership agreement
- Approval of partner promotion, evaluation, compensation, disciplinary actions and termination
- Approval of the annual financial budget and annual financial statements
- Approval of the annual business strategy
- Selecting the managing partner and chairman of the board
- Oversight of the firm's independence and quality control policies and procedures



## *Executive leadership team*

McGladrey's Enterprise Leadership Team assumes responsibility for the firm's system of quality control. The Enterprise Leadership Team consists of the firm's managing partner, chief operating officer, chief financial officer, chief risk officer, general counsel, industry leader and the national line of business leaders for assurance, tax and consulting. The following individuals are primarily responsible for ensuring that our firm complies with applicable professional assurance standards and regulatory requirements:

- **Joe Adams, managing partner and CEO**, accepts overall responsibility for our system of quality control and promoting a quality-oriented culture. The managing partner also directs the management and strategy of the firm's overall practice, including the assurance practice.
- **Mike Kirley, chief operating officer**, is responsible for assisting the firm's regions in establishing and attaining their performance goals. As part of the firm's Enterprise Leadership Team, Mr. Kirley is actively involved in implementing the firm's strategy.
- **Jim Morton, national assurance leader**, oversees our assurance practice, including the National Professional Standards Group, which establishes the firm's assurance policies and guidance. The National Professional Standards Group develops and updates our general and industry-specific assurance policies and methodologies, and related guidance, tools and training. They also consult with client servers on technical matters. Members of our National Professional Standards Group represent our firm on various professional committees and organizations, and contribute comment letters on proposed professional standards, rules and regulations. In addition, Mr. Morton oversees our regional assurance leaders.
- **Bruce Jorth, chief risk officer**, oversees the National Office of Risk Management. Mr. Jorth works directly with the national assurance leader and others to refine our understanding and assessment of risks and to facilitate the development of key strategies that appropriately balance and focus our risk management efforts. The National Office of Risk Management establishes and monitors the firm's quality control processes, including managing our internal and coordinating our external inspections. The independence, licensing and regulatory compliance functions also are assigned to this group, as well as the responsibility for professional liability matters.
- **Doug Opheim, chief financial officer**, is responsible for the firm's debt and equity financing and financial systems, reporting and planning. He also manages the firm's financial risks, mergers, individual partner short-term and long-term compensation and information technology systems.
- **Rick Miller, general counsel**, manages the firm's professional liability litigation, ethics and regulatory investigations, and employment claims and litigation. Mr. Miller is a CPA and has been the firm's general counsel since 1987. He works closely with the chief risk officer in the development of risk management policy for the firm.

In addition, regional assurance leaders in our five defined geographic regions – West, Central, Great Lakes, Northeast and Southeast – are responsible for managing the assurance services practice and personnel within their respective regions. Regional assurance leaders report to the national assurance leader and the five regional managing partners. Regional managing partners are responsible for all aspects of our business in their region and report to the chief operating officer.

## ***International network***

Our firm is one of the founding members of RSM International (RSM). RSM is the seventh largest worldwide network of independent accounting and consulting firms (source: *International Accounting Bulletin*). RSM member firms comprise 32,000 people from approximately 700 offices located in more than 100 countries. RSM has strict membership criteria, and all members must adhere to stringent inspection and training programs. Members must be well-established practices of high local standing, generally ranking within the top 10 in their own locality.

RSM is a member of the Forum of Firms, an association of international networks of accounting firms that perform audits of financial statements that are or may be used across national borders. The Forum works with the International Federation of Accountants to support the work of independent standard-setting boards and to promote adoption of international standards. Members of the Forum are committed to promoting consistent and high-quality standards of financial reporting and auditing practices worldwide.

RSM has developed and implemented global audit methodologies and tools, and maintains an ongoing program of annual globally coordinated inspections to assess compliance with applicable professional standards and alignment with RSM policies, procedures and methodologies. Each member firm must maintain a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements for all professional services provided by the firm, and that reports and any other deliverables issued or provided by the firm or its personnel are appropriate and suitable in the circumstances.

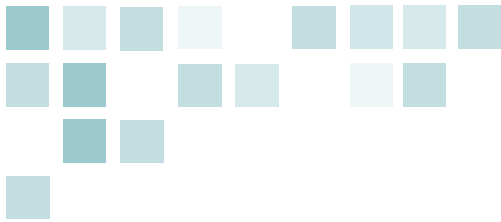
Certain RSM member firms actively provide services to foreign components of our U.S. clients and have professionals who are familiar with U.S. generally accepted accounting principles (GAAP), relevant auditing standards, independence rules and financial reporting requirements. Use of these member firms is determined on an engagement-by-engagement basis and is supplemented by interoffice instructions and direct involvement by McGladrey professionals, including expatriates located in Europe and Asia. When McGladrey audit engagements require the assignment of professionals in RSM member firms, our International Assurance Services Group assists U.S. and foreign audit teams in the planning, supervision and review of international engagements to ensure compliance with applicable U.S. professional standards.

McGladrey and RSM International have developed enhanced training directed at RSM member firms that function as a component auditor for audit engagements performed under U.S. generally accepted auditing standards (GAAS) or Public Company Accounting Oversight Board (PCAOB) auditing standards. The training focuses on U.S. GAAP, U.S. GAAS/PCAOB auditing standards, and SEC/PCAOB independence and ethics rules.

## ***Professional organizations***

McGladrey is a founding member of the Center for Audit Quality, and we actively participate in its various committees and task forces, including the Governing Board, Professional Practice Executive Committee and SEC Regulations Committee. National office assurance leaders also serve on the PCAOB Standing Advisory Group, SEC Advisory Committee on Small and Emerging Companies and U.S. Government Accountability Office (GAO) Advisory Council on Government Auditing Standards.

We require all professionals who are CPAs to be members of the American Institute of Certified Public Accountants (AICPA), and we actively participate on various AICPA committees, task forces and expert panels, including the AICPA Auditing Standards Board, Professional Ethics Executive Committee, National Peer Review Committee, and Governmental Audit Quality Center and Employee Benefit Plan Audit Quality Center Executive Committees. This participation provides immediate, first-hand knowledge of proposed and final standards and other developments affecting our clients and audit quality.



## Our quality control system

Our system of quality control for our assurance practice is designed to provide reasonable assurance that our firm and our personnel comply with professional standards and applicable regulatory and legal requirements, and that our firm and its engagement partners issue reports that are appropriate in the circumstances. The elements of the system of quality control are established by Statements on Quality Control Standards issued by the AICPA and the requirements of the PCAOB. Those standards and requirements and our system of quality control encompass:

- Leadership responsibilities for quality control within the firm
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

Our system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. Our firm communicates these policies and procedures in writing and makes the documentation available electronically to all personnel. Our firm requires each individual to be familiar with these policies and procedures, and emphasizes that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures.

*“Our leadership team sets clear expectations for high-quality performance on the part of all of our professionals. It is the responsibility of everyone in our firm to meet those expectations.”*

Bruce Jorth, chief risk officer

### ***Leadership responsibilities for quality control within the firm***

Our firm provides leadership in achieving high-quality professional performance within the framework of individual accountability. Our leaders promote a quality-oriented culture based on the recognition that quality is essential to meeting our professional responsibilities and achieving our business objectives. Firm leadership sets a tone at the top that emphasizes quality as a critical component of our business strategy. It is expected that each engagement partner establishes a tone at the top for the engagement team that emphasizes high audit quality and excellent client service.

The operational responsibility for the quality control system is assigned to our National Professional Standards Group, National Office of Risk Management and Regional Professional Practice Offices, whose personnel have sufficient and appropriate experience and expertise to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

Our National Professional Standards Group, which consists of the Accounting Standards Group, Assurance Standards and

Methodology Group and Specialized Services Group, is led by Jim Morton, national assurance leader. Our National Office of Risk Management, which monitors engagement quality and regulatory compliance, is led by Bruce Jorth, chief risk officer. We have three Regional Professional Practice Offices, each of which is led by a senior technical assurance partner. The Regional Professional Practice Offices assist our engagement partners by consulting on engagement-specific accounting and auditing matters.

## *Relevant ethical requirements*

We believe in and uphold professional and personal integrity. Our partners and employees are expected to practice to the highest standards of performance and behavior and to perform all services with the objectivity and professional skepticism required by our professional standards. We establish policies and procedures designed to provide reasonable assurance that personnel comply with independence, integrity, objectivity and other relevant ethical requirements. These requirements include regulations, interpretations and rules of the AICPA, SEC, PCAOB, GAO, U.S. Department of Labor, state CPA societies, state boards of accountancy and other applicable regulators.

All McGladrey partners and other professionals are expected to adhere to all applicable provisions of the AICPA Code of Professional Conduct, as well as applicable ethics requirements of the PCAOB and the state boards of accountancy. In addition, our firm maintains a Code of Business Ethics and Conduct and requires partners and employees to annually affirm their awareness of, and compliance with, the Code of Business Ethics and Conduct. We maintain a confidential ethics hotline that allows any McGladrey employee, client or vendor who sees, suspects or knows about fraudulent, illegal or unethical behavior to report it.



Our firm establishes clear and concise written guidance covering relationships and activities that impair independence, including, but not limited to, investments, loans, brokerage accounts, business relationships, employment relationships and fee arrangements. Our chief risk officer and national director of independence and regulatory compliance ascertain that policy statements reflect the latest significant pronouncements of all applicable regulatory authorities. Our independence and relationship policies are made available electronically to all employees.

Professional employees are advised of our policies during the orientation process and are reminded of our policies annually as a part of monitoring compliance with such policies. Our firm emphasizes independence and other ethical considerations in selected training programs, with required training near the time of initial employment and with particular emphasis in entry-level programs. The firm requires periodic independence and ethics training for all professional employees and partners. Individuals' security holdings in brokerage accounts are monitored by a web-based investment-tracking system that compares such holdings to our restricted entities listing.

All professionals represent in writing to the national director of independence and regulatory compliance their compliance with policies, including any exceptions, near the time of initial employment and on an annual basis thereafter. Exceptions are approved by the national director of independence and regulatory compliance, with certain matters subject to the approval of the McGladrey board of directors. The firm audits a sample of these annual independence representations by reference to income tax, bank account and brokerage account records. The Risk Oversight Committee of the board of directors establishes guidelines setting forth the consequences for professional personnel who violate our independence policies or procedures.

In cases in which our firm provides both audit and nonaudit services, we evaluate our ability to perform nonaudit services and remain independent to provide audit services. Our professionals are educated about prohibited nonaudit services, and it is the audit engagement partner's responsibility to monitor the nonaudit services to be performed. Our professionals consult with our Regional Professional Practice Offices or our national director of independence and regulatory compliance when they have questions regarding a particular service.

On all public entity audit engagements, we seek audit committee preapproval to perform nonaudit services that are not otherwise prohibited by rules or regulations of the SEC or PCAOB. When seeking audit committee preapproval to perform permitted tax services or other nonaudit services, we describe, in writing, to the audit committee the scope of the proposed service, and discuss with the audit committee the potential effects of the proposed services on the independence of the firm. We provide the audit committee a robust foundation of information sufficient for it to distinguish between services that could have a detrimental effect on our independence and those that would be unlikely to do so. The scope of our discussion with the audit committee remains flexible to address the matters that are pertinent in the judgment of the audit committee.

During the planning stage of all public entity audit engagements, the engagement team must ensure that the audit engagement partner, engagement quality reviewer and all other audit partners have complied with the SEC and PCAOB partner rotation requirements. Our national director of SEC services also monitors compliance with these requirements and approves the assignment of all audit engagement partners and engagement quality reviewers.

## ***Acceptance and continuance of client relationships and specific engagements***

We establish policies and procedures for the acceptance and continuance of client relationships and specific engagements designed to provide reasonable assurance that we will undertake or continue relationships and engagements only where we: (a) have considered the integrity of the client and the risks associated with providing professional services in the circumstances, (b) are competent to perform the engagement and have the capabilities and resources to do so, (c) can comply with the applicable legal and ethical requirements, and (d) can reach an understanding with the client regarding the nature, scope and limitations of the services to be performed.

Just as our clients are selective in their choice of CPA firms, we are selective in accepting clients. Our robust client acceptance and continuation policies and procedures require the prospective engagement partner to carefully evaluate the prospective client prior to acceptance by:

- Evaluating the integrity and competence of top management and majority owners
- Evaluating the prospective client's financial condition
- Reviewing our independence requirements to determine compliance with respect to the prospective client
- Ensuring that qualified professional staff and other functional and industry specialists are available
- Communicating directly with the predecessor auditor





Acceptance of all prospective clients must be approved by the regional assurance leader or his or her designee. Acceptance of prospective clients who are public entities also requires the concurrence of the national director of SEC services. Acceptance of certain prospective clients requires the concurrence of the respective industry leader. In addition, specific factors identified during the acceptance or continuance process subject the engagement to certain levels of monitoring or other review by the Regional Professional Practice Office and/or the National Office of Risk Management, including approval by the chief risk officer.

The engagement partner must initiate a re-evaluation of each assigned audit client prior to each year's engagement. Factors to be considered include, but are not limited to, a significant change in top management, a significant change in the nature, size or structure of the client's business, and certain prior-year audit findings. The engagement partner must obtain concurrence with client continuance from the regional assurance leader or his or her designee. When certain engagement risk criteria are present, the approval of the Regional Professional Practice Office, the national director of SEC services, the industry leader and the National Office of Risk Management is also required. Finally, for higher-risk public entities and financial institution and financial services clients, approval for acceptance or continuance of the client relationship must be obtained from our Client Acceptance and Re-evaluation Committees. These committees evaluate engagement staffing requirements, the identification of significant risks of material misstatement, consultation requirements and the need for the involvement of subject matter experts.

Our firm uses the McGladrey Risk Assessment Model, an electronic tool that assists engagement teams in performing consistent and comprehensive evaluations of engagement risk and provides our assurance leadership with deeper insight into the risk profile of our client portfolio. In arriving at an engagement risk assessment, the McGladrey Risk Assessment Model considers several risk-rating factors, such as industry, financial condition, governance, management, control environment, size, complexity and international reach.

In addition to providing for the approval of engagement acceptance or continuance and engagement staffing, this tool identifies potential risks of material misstatement, the need for the involvement of subject matter experts, matters requiring consultation and other engagement risks. Early identification of issues and risks allows us to plan and perform more effective and efficient risk-based audits. This tool also provides information that is used to more effectively evaluate our client portfolio at the partner, industry and firmwide levels.

## *Human resources*

We establish policies and procedures designed to provide reasonable assurance that we have sufficient professional personnel with the capabilities, competence and commitment to ethical principles necessary to perform our engagements in accordance with professional standards and regulatory and legal requirements and to enable our firm to issue reports that are appropriate in the circumstances. Our personnel management begins with hiring the right people.

Our firm proactively seeks to employ individuals who possess high levels of intelligence, integrity, honesty, motivation and an aptitude for the profession. We establish minimum qualifications and guidelines for evaluating potential hires and ensuring that personnel who are hired possess the appropriate characteristics to enable them to perform competently. Campus recruiting activities are delegated to experienced professionals who have been provided with both formal and informal training in the selection process. We perform background checks on all new and experienced hires.



### *Assignment of engagement personnel*

Capabilities and competence are developed through professional education, continuing professional development, work experience and mentoring by more experienced personnel. Our firm has established qualification and performance expectations for the various levels of responsibility within the firm.

The National Office of Risk Management, in consultation with our Regional Professional Practice Offices, approves a list of assurance partners, directors and other professionals who have designations within our quality control system. This list identifies individuals by industry and engagement risk rating who are authorized to serve as engagement partners and managers, engagement quality reviewers, industry specialists, independent report reviewers, SEC compliance reviewers and subject matter experts.

Our firm assigns an individual to a specific engagement after considering the professional competence and industry experience of the individual, together with the degree of knowledge, skills and abilities required in the circumstances. Our policies also require the assignment of internal information technology, tax, valuation and other specialists in appropriate circumstances. In addition, these policies provide guidance on the responsibilities to be discharged by various members of the engagement team.

## *Professional development*

At McGladrey, we always have focused on training all our professionals to make sure they are proactively prepared to meet the challenges of our profession. We take a holistic approach to training and develop a strategy for all professional levels within the firm. We have an annual learning and professional development planning process that includes an assessment of participant needs as compared to our existing curriculum to identify new program needs and necessary revisions to existing programs and to budget adequate resources to achieve training objectives. This process includes input from national leaders, as well as focus groups and auditors who are practicing in the field, which results in more current and relevant training that is adapted for changing professional standards and responsive to inspection findings.

The professional development policies, curriculum (required and elective) and training schedule are determined by the National Professional Standards Group and National Office of Risk Management in consultation with the National Assurance Learning Governance Council, and are communicated to our professionals through our online catalog. Each professional assumes the responsibility to see that his or her curriculum fits acceptably within the annual guidelines. Our Regulatory Compliance group monitors compliance with the guidelines.

Professional personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements. Course materials are provided electronically to our auditors, allowing them to easily apply what they learned in our practice environment.

*“Audit quality is the cornerstone of our profession, and we believe continuous improvement is key to audit quality. Our professional development program helps our professionals take personal responsibility for making continuous learning a high priority.”*

*Jim Morton, national assurance leader*

Self development is encouraged as an important element of professional development. In connection therewith, our firm has acquired, on an electronic subscription basis, professional standards promulgated by the Financial Accounting Standards Board, Governmental Accounting Standards Board, AICPA, GAO, Office of Management and Budget and PCAOB. Our manuals are revised and updated on a periodic basis and made available to all assurance services personnel through electronic databases. Each professional receives our newsletter of professional developments on a biweekly basis.

Our firm recognizes that on-the-job development is a significant component of professional development. Partners, directors and managers are encouraged, and often required, to perform their reviews at the client’s location where they can coach and provide feedback to staff. This allows the knowledge, experience and values of these more experienced professionals to positively impact on-the-job training, while enhancing audit quality. Timely engagement evaluations provide our professional staff with instructive feedback on their engagement performance. Advanced professionals are evaluated, in part, on their effectiveness in training and developing others.

### *Individual performance evaluation*

Our professionals participate in annual goal-setting and performance evaluation processes. Many elements are considered when evaluating an individual's performance. These elements include quality, client service and expertise, people management and relationships, and productivity and business growth. The attainment of audit quality goals is incorporated in the evaluation/compensation of our assurance professionals. All professionals also are assessed against our values of respect, integrity, teamwork, excellence and stewardship.

The results of the performance evaluations have a direct effect on compensation and promotion. Individuals being recommended for promotion to partner must go through an extensive nomination, interview and internal vetting process. Our national and regional leaders have extensive input in the promotion process. The final list of promotions is approved by the managing partner and the firm's board of directors.

Our firm's partner evaluation and compensation program is administered by the Income Allocation Committee of the firm's board of directors and the five regional managing partners. An important component of the partner evaluation is the assessment of quality. The regional assurance leaders use a quality assessment tool to assess the performance quality of assurance partners. This tool includes, among other information, a quality rating for all engagements that have been subjected to inspection or monitoring. The quality ratings are important factors in determining partner compensation. The board of directors approves the annual partner compensation plan and individual partner compensation, including special recognition for outstanding performance and penalties imposed for material breaches of professional standards and firm policies.

### *Engagement performance*

We establish policies and procedures designed to provide reasonable assurance that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and that we issue reports that are appropriate in the circumstances. We implement these policies by developing, maintaining, and providing personnel with our electronic manuals, software tools and subject-matter guidance materials, which address:

- Our audit methodology
- Engagement supervision, including the timing and extent of the various levels of engagement review
- Appropriate documentation of the work performed
- Identifying matters for consultation or consideration by more experienced professionals



## *Our audit methodology*

Our National Professional Standards Group has developed and regularly updates our audit methodology and related guidance and tools. This includes enhancements to our McGladrey Audit Performance System, which allows for consistent and thorough electronic documentation of procedures performed, while requiring the application of professional judgment in the design and performance of the procedures.

Our audit approach is carefully designed to comply with professional standards, providing a high level of audit quality and an appropriately low level of business risk. The audit approach is founded on a thorough understanding of the client's business, including its financial reporting and business control environments. Our understanding of the client's business also focuses on obtaining an understanding of internal control that is sufficient to identify and assess the risks of material misstatement and then developing an audit plan that is responsive to those risks.

*"High-quality engagement performance starts by taking the time to really understand the client's business and internal control over financial reporting. Planning and executing an effective audit then follows logically from our in-depth understanding of the client, its transactions and the industry in which it operates."*

Joe Adams, managing partner and CEO

The engagement team is required to plan the audit work so that an effective audit is performed, designing procedures that are responsive to the fraud and other risks of material misstatement identified. The nature, timing and extent of procedures performed are consistent with risk assessments made and the approach described in the planning documentation. The appropriateness of planned procedures is reconsidered when significant changes in risk factors are identified during the execution of tests of controls and substantive procedures.

Our monograph, *Using Professional Judgment in Auditing*, describes the professional judgment framework we expect our auditors to use in identifying risks of material misstatement, planning audit procedures to respond to identified risks, and reaching conclusions based on the audit evidence. We train our auditors on the use of this framework and ask that they make the concepts in this document a reality by integrating them into the professional judgments they make on a daily basis. We are committed to investing in and achieving a culture of exercising sound professional judgment and exercising the objectivity and professional skepticism required by our professional standards.

## *Engagement supervision*

Various levels of engagement review, including by the senior in-charge, manager and partner, are used to document the supervision and review of the engagement performed by engagement supervisory personnel. An engagement quality review is required for audits of public companies and in a number of other circumstances. This review provides additional assurance with respect to the financial statements and our report thereon, the sufficiency of evidential matter obtained and the audit conclusions reached. An SEC compliance review is required when the financial statements and our report thereon will be included in a filing with the SEC or comparable federal or state agency. The purpose of this review is to provide reasonable assurance that the financial statements, disclosures and other aspects of the filing are in compliance with applicable regulations and that the disclosures in the related document are consistent with the financial statements.



## Consultations

Our firm expects its professionals to seek assistance from persons possessing specialized knowledge and expertise whenever they encounter situations where they lack sufficient knowledge and experience, and in certain specific situations prescribed by our consultation policy. Our firm has designated subject matter experts (SMEs), industry specialists, SEC compliance reviewers and engagement quality reviewers who provide professionals with access to knowledge and expertise in a variety of specialized, complex and/or unusual areas. Certain situations prescribed by our policy require consultation with the National Professional Standards Group. More than 80 percent of these consultations are initiated through our Regional Professional Practice Office personnel, who are dedicated to providing support to our professionals in the areas of auditing, accounting, financial reporting and SEC reporting. This structure allows for both improved client service and audit quality as decisions are typically made locally and closer to clients.

Consultations with SMEs are required in certain situations identified through the operation of the McGladrey Risk Assessment Model. The engagement leader is responsible for ensuring that the engagement team contacts the designated SME during the planning phase of the engagement to determine the nature, timing and extent of the SME's involvement. Based on the specific facts and circumstances of the engagement, the SME will determine the extent of his or her involvement and the potential assignment of other specialists to assist the engagement team.

Our firm has policies and procedures for resolving differences of opinion within the engagement team and with those consulted. These procedures require documentation regarding the resolution of the differences and the implementation of the conclusions reached. A report cannot be issued until a matter involving differences of opinion is resolved in accordance with the relevant policies. Disagreements ultimately are resolved by the national assurance leader or chief risk officer, whose decisions represent the final firm position with respect to the resolution of assurance-related matters.

## Monitoring

Accountability is a critical element of any quality control system. We establish monitoring policies and procedures designed to provide reasonable assurance that the policies and procedures relating to our system of quality control are relevant, adequate, operating effectively and complied with in practice. In assuring that our quality control policies and procedures remain relevant and adequate, we consider changes in professional standards or other regulatory requirements applicable to our practice. We also consider other external factors, such as industry trends, economic developments and emerging audit quality issues. Our national director of practice quality is responsible for the monitoring process.





The firm's internal inspection program is designed to evaluate compliance with McGladrey's system of quality control for its assurance practice through an annual review of the elements of quality control and inspection of the work performed for a sample of audit engagements. The internal inspection program has two distinct elements – inspection and functional monitoring.

Engagements are selected by the National Office of Risk Management for inspection using a risk-based approach and are primarily focused on engagements in the

higher risk zones as determined by the McGladrey Risk Assessment Model discussed above, and partners primarily serving clients in those same zones. The inspections are performed so as to cover one-third of all partners annually.

Quality results not only from the procedures performed on specific engagements, but also from certain general functions administered by local offices and national groups that have an impact on all engagements. The National Office of Risk Management assesses the quality of the design and operation of these functions by monitoring the risks and controls existing in the following areas:

- Independence
- Continuing professional education
- Partner and employee evaluations
- Regulatory relations

A web-based tool is used to gather, sort, store and use information obtained through our monitoring programs.

Engagement-specific results, along with an engagement-quality rating, are reported to the engagement partner and the regional assurance leader. Inspection findings are remediated, as required by professional standards. The results of all inspections are accumulated and reported to the firm's board of directors.

## Identifying areas for improvement

At McGladrey, we are dedicated to continuously improving our quality control system and our overall audit quality. We identify areas for improvements in a variety of ways – primarily by evaluating the root causes underlying our internal inspection findings and the findings from our external peer review and PCAOB inspection. We believe that our processes can always be improved as a result of lessons learned from internal and external monitoring.



### *External monitoring*

In accordance with the Sarbanes-Oxley Act of 2002, our firm is subject to inspection by the PCAOB on an annual basis. We support the PCAOB's inspection process and believe that its inspection comments and observations have helped us enhance the quality of our audit engagements.

The most recent report issued by the PCAOB with respect to its inspections of our firm is the 2012 inspection report, issued on February 27, 2014. The 2012 inspection included, among other matters, reviews of audits of financial statements for

years ending from April 1, 2011 through March 31, 2012. The PCAOB's 2013 inspection included reviews of audits of financial statements for years ending from April 1, 2012 through March 31, 2013, and the report on that inspection has not yet been issued. The 2014 inspection, covering audits of financial statements for years ending from April 1, 2013 through March 31, 2014 is substantially complete, but the inspection report will not be issued for some time.

The PCAOB report on each inspection includes a public portion and a nonpublic portion. The public portion includes an overview of the PCAOB's inspection procedures and the PCAOB's observations on certain of the engagements subjected to inspection. The nonpublic portion of each inspection report reflects the PCAOB's observations about the firm's audit performance as a whole and its system of quality control. The PCAOB's comments within the nonpublic portion of its most recent report were generally consistent with the findings in the public portion.

Our firm also is subject to the triennial peer review requirements of the AICPA. The peer review focuses on the firm's non-SEC audit practice and is conducted by another licensed CPA firm. McGladrey's system of quality control for the accounting and auditing practice applicable to non-SEC issuers, in effect for the year ended April 30, 2013, was subject to peer review by the firm of BKD, LLP. Under the peer review standards, firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. Our firm received a peer review rating of *pass*.

We address any findings of our internal and external inspections, such as the PCAOB inspection and our peer review, in a timely manner. We carefully evaluate the root causes of the matters identified by our external inspections and initiate actions to remediate and address such matters. We prepare a written response to the nonpublic portion of the PCAOB report indicating our plans to improve audit quality as a result of their inspection findings.



## *Quality Control Inquiry Committee*

McGladrey is committed to using the comments and observations resulting from our internal and external inspections to improve our system of quality control. In that regard, our firm has implemented a Quality Control Inquiry Committee (QCIC). The QCIC's voting members include the firm's chief risk officer, national assurance leader and our former executive partner – National Professional Standards Group. Advisory members to the committee, as appropriate, include partners in the National Office of Risk Management and National Professional Standards Group and various national industry leaders. The QCIC reports to the Risk Oversight Committee of the firm's board of directors.

Engagements to be addressed by the QCIC are selected based on certain triggering events such as engagements identified in PCAOB or internal inspections or in the peer review process for which additional audit procedures were required to support the firm's report or for which a material departure from the applicable financial reporting framework was identified and it is determined that recall or restatement is required, regulatory investigations, and restatements identified during the consultation process. In addition, engagements and partners may be referred to the QCIC by the firm's Client Acceptance and Review Committees and other groups within the firm.

For engagements subject to review, first and foremost, the QCIC attempts to determine the root cause of the audit deficiencies. By understanding the root cause, the appropriate response can be developed, which may consist of revising policies, issuing guidance or communications, or developing training. The firm believes understanding the root cause is key to improving future performance.

On those rare occasions where the QCIC determines that the audit deficiency resulted from a lack of due care on the part of engagement supervisory personnel, the QCIC will issue a letter of reprimand or will require corrective action, such as attending specified training, subjecting the individual's work to additional oversight or the restriction of partner authorities. In the event the root cause is determined to be behavior for which disciplinary action is appropriate, the QCIC recommends to regional management, the Risk Oversight Committee of the McGladrey board or other parties the action to be taken, including recommendation for negative adjustments to a partner's compensation. QCIC conclusions also are communicated to regional leaders for consideration in the partner evaluation/reward process.

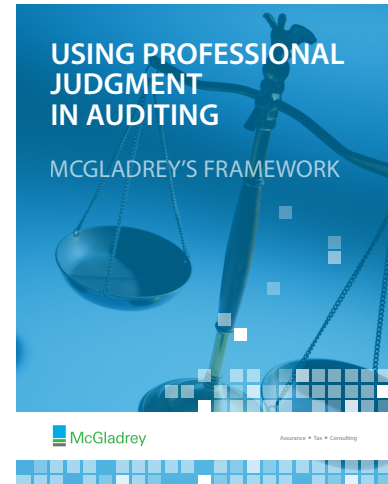
QCIC reviews to date have resulted in various actions to improve audit quality, such as recommendations to the National Professional Standards Group and National Office of Risk Management regarding changes in policies and procedures, revisions to national training programs, additional internal communications on specific audit issues, and disciplinary actions for individuals. The firm believes the QCIC process has been very beneficial in determining the root cause of identified audit deficiencies and in reinforcing a tone at the top that elevates the quality of our assurance practice. The QCIC process is not only important in sustaining audit quality, but also in identifying areas for improvement and in enhancing firm policies and related tools.

## Continuous improvement

After evaluating all of our internal and external monitoring processes, we have identified the following areas where we believe improvements can and should be made in our system of quality control:

- Improving professional judgment when auditing accounting estimates
- Improving systems for measuring the effectiveness of our continuing professional education courses

Our improvement initiatives encompass a four-pronged combination of actions steps – revising our audit policies; revising our McGladrey Audit Performance System and related practice aids; revising our existing training programs or initiating new training programs; and monitoring the effectiveness of our actions. We find that with continuous focus, results can be achieved. Following are brief descriptions of the initiatives mentioned above.



### ***Improving professional judgment when auditing accounting estimates***

In May 2012, we published our monograph, *Using Professional Judgment in Auditing*, which we developed with the assistance of three professors from the Brigham Young University School of Accountancy. The monograph describes the professional judgment framework we expect our auditors to use in reaching conclusions based on the audit evidence. We train our auditors on the use of this framework and incorporate it into our education programs at all levels. This training includes detailed instruction about avoiding biases and judgment traps that can compromise professional judgment. In addition, the training presents specific frameworks that are built from the professional judgment framework, such as the framework for the use of judgment in analytical procedures and in identifying and responding to the risk of material misstatement due to fraud.

We have begun the process of redesigning our tools and audit programs to reflect the professional judgment framework. We are committed to investing in and achieving a culture of making sound professional judgments, exercising the objectivity and professional skepticism required by our professional standards. During 2014, all auditors at the senior associate level and above are required to attend our *Accounting Estimates and the McGladrey Professional Judgment Framework* course.

### ***Improving systems for measuring the effectiveness of our continuing professional education courses***

Effective training is essential in an audit firm because it enables our professionals to provide high-quality services and comply with professional standards. Further, high-quality training is a key factor in employee engagement and retention. Annually, our firm invests millions of dollars in training. Due to the significant investment in, and value derived from, training we believe it is important to develop a comprehensive learning strategy that includes a feedback loop regarding the success of our training.

Under the direction of our chief risk officer, we have established a National Assurance Learning Governance Council that is focused on the effectiveness of training. The council consists of four advisory councils that concentrate their efforts on (a) proficiency and curriculum, (b) instructor evaluation, (c) course evaluation and individual accountability and (d) integrating innovative learning methods.

We are developing methods to measure learning effectiveness, including through our internal inspection function and through testing of course participants. We have piloted participant testing to measure the effectiveness of certain of our courses. During 2014 we will continue to provide participant testing in some required courses and also will continue to measure course effectiveness through our internal inspection function.

## Looking to the future

Accounting and auditing standards are constantly changing in response to economic developments and user expectations. The Financial Accounting Standards Board and the International Accounting Standards Board recently issued converged accounting standards on revenue recognition. These standards will affect the revenue recognition policies of almost all entities. In addition the Public Company Accounting Oversight Board and the International Auditing and Assurance Standards Board have significant projects in process, including measuring audit quality and potentially significant changes to the auditor's standard report. We anticipate that these projects could have an impact on private company auditor reporting, especially in the financial institution and insurance industries.

As these accounting and auditing standards become effective, we must constantly revise our audit policies, methodologies and tools, as well as other elements of our quality control system. We are committed to keeping pace with the rapidly changing world in which we operate, and we are looking forward to the challenge of maintaining and continuously improving our overall audit quality. As a firm, we are committed to making the necessary investments to provide the users of our reports with a high level of assurance that the financial statements upon which they rely are free of material misstatement.



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