

**Report on**  
**2004 Inspection of Deloitte & Touche LLP**  
Issued by the  
**Public Company Accounting Oversight Board**  
October 6, 2005

**THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT**

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED  
FROM THIS DOCUMENT IN ORDER TO COMPLY WITH  
SECTIONS 104(g)(2) AND 105(b)(5)(A)  
OF THE SARBANES-OXLEY ACT OF 2002**

**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 DELOITTE & TOUCHE LLP**

In 2004, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted an inspection of Deloitte & Touche LLP ("Deloitte" 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.<sup>1/</sup>

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.<sup>2/</sup> 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.

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<sup>1/</sup> 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.

<sup>2/</sup> 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 the Firm from May 2004 to November 2004. The inspection team performed field work at the Firm's National Office and at 26 of its 64 practice offices. Appendix B to this report provides a detailed description of the procedures the inspection team performed.

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 the seven 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.<sup>3/</sup> 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.

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<sup>3/</sup> 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 issuer 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 some cases, 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,<sup>4/</sup> 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.<sup>5/</sup>

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

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<sup>4/</sup> 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).

<sup>5/</sup> The Board inspection process 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.

issuer's financial statements. In some of those audits, that conclusion followed from the 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).<sup>6/</sup>

#### Issuer A

The issuer is a wholly-owned subsidiary of another issuer (the "Parent"). Two days before the anticipated date of the issuer's filing of the Firm's audit report with the SEC, the issuer informed the Firm that the recorded value of its interest-only strip assets ("I/Os") and the related interest income were overstated. At the time that the issuer told the Firm of the overstatement, the issuer changed the assumptions it used to calculate the gains for three securitization transactions completed during the fiscal year (two of which had been previously reported in interim filings with the SEC and the third was included in the entire year's financial results that were disclosed in an earnings release), resulting in additional gains on those transactions and offsetting the correction of the income overstatement on its I/Os and interest income. As a result, the issuer's net income for the year, which had previously been disclosed in the earnings release, remained unchanged.

The Firm devoted less than two days to completing audit procedures related to these issues, and allowed the issuer to proceed with the revised accounting for the securitization transactions. The Firm told the inspection team that adjustments for two of the transactions represented corrections of errors caused by the issuer's use of erroneous assumptions, but the Firm's work papers included no indication that those assumptions had been erroneous.<sup>7/</sup> In addition, formal communications from both the Firm and the issuer to the audit committee of the issuer's Parent did not characterize the adjustments as error corrections, nor were these adjustments disclosed as corrections

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<sup>6/</sup> 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.

<sup>7/</sup> The Firm had previously audited one of these transactions during the fiscal year 2002 financial statement audit in connection with a "subsequent events" disclosure regarding a transaction completed in the first quarter of fiscal 2003.

of errors in the financial statements filed by the issuer. During the inspection fieldwork, the issuer informed the Firm that a portion of the error in interest income had previously been corrected and, therefore, a portion of the year-end adjustment the issuer had already recorded was not necessary.<sup>8/</sup>

In addition, the work papers failed to evidence that the Firm evaluated whether the issuer accounted for the I/Os at fair value and the accounting policy disclosure in the financial statements did not indicate whether the I/Os were accounted for at fair value after securitization. Moreover, the financial statements did not disclose certain information regarding key assumptions used to measure the fair value of the I/Os retained at the balance sheet date, as required by Statement of Financial Accounting Standards ("SFAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and the Firm should have identified and addressed the issuer's failure to disclose the required information.

#### Issuer B

The issuer's financial statements reflected an impairment charge related to the shutdown of a manufacturing facility. An error in the computation of the impairment charge caused the amount of the charge to be overstated. The issuer also misclassified certain amounts within the statement of cash flows. The Firm should have identified and addressed these errors before issuing its audit report.<sup>9/</sup>

#### Issuer C

The issuer accounted for a balance under a revolving line of credit as a long-term liability, despite the presence of conditions that made such accounting inappropriate under Emerging Issues Task Force ("EITF") No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a*

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<sup>8/</sup> The issuer has restated certain of its financial statements to make changes relating to each of the matters described here. The Board inspection process did not include any review of any additional audit work or the restated financial statements.

<sup>9/</sup> The issuer has restated its financial statements to make changes relating to the matters described here. The Board inspection process did not include any review of any additional audit work or the restated financial statements.

*Subjective Acceleration Clause and a Lock-Box Arrangement.* Because the loan agreement contained both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances whereby remittances from the borrower's customers immediately reduce the outstanding obligation, the balance should have been classified as a current liability. The misclassification caused an understatement of current liabilities and an overstatement of working capital.<sup>10/</sup> The Firm should have identified and addressed the incorrect accounting.

Issuer D

On this audit –

- The issuer accounted for lease incentives received from landlords as a reduction of depreciation expense, rather than as a reduction of rental expense as is required by EITF No. 88-3, *Rental Concessions Provided by a Landlord* and FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*. This treatment resulted in an understatement of depreciation expense and an overstatement of lease expense, as well as an understatement of deferred liabilities and fixed assets.<sup>11/</sup> The Firm should have identified and addressed the incorrect accounting.
- The Firm relied on certain controls, in particular general computer controls, automated application controls and security controls, without performing, or without documenting in the work papers the performance of, sufficient testing to support reliance on those controls. Deficiencies included: (1) the Firm's documented testing of certain controls only covered activities occurring outside the audit period, (2) the Firm's work papers indicated that it used reports generated by the payroll department to perform certain tests of controls, but the Firm did not document any test

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<sup>10/</sup> The issuer has restated certain of its financial statements to make changes relating to the matter described here. The Board inspection process did not include any review of any additional audit work or the restated financial statements.

<sup>11/</sup> The issuer has restated certain of its financial statements to make changes relating to the matter described here. The Board inspection process did not include any review of any additional audit work or the restated financial statements.

work over the completeness of those reports, (3) the Firm did not document the sample sizes, or how they were determined, for the testing of certain controls, (4) the Firm's work papers indicate that it relied on an instruction manual as documentation that a control existed and operated effectively without indicating how the manual supported that conclusion, and (5) the Firm did not document its testing or understanding of certain key relevant systems and system controls of another company that had merged with the issuer during the year.

- The issuer engaged specialists to value properties and favorable lease agreements acquired in a significant merger during the year, but the work papers failed to evidence any evaluation of assumptions and methods used by the specialists or the results of the specialists' work.
- The Firm failed to demonstrate it had assessed the assumptions used by the issuer in recording accrued liabilities on a sublease associated with a significant store closing. In addition, there was no evidence that the Firm evaluated the reasonableness of management's estimate used to record the provision for inventory shrinkage.

#### Issuer E

Because of power supply issues in a country, the output of the issuer's plant in that country was severely curtailed in 2003. The issuer entered into discussions with the government to sell the facility and determined that, at the low end of the range of potential sales prices, the book value of the facility could be impaired by an amount up to four percent of the issuer's net loss for the year ended December 31, 2003. The issuer determined, however, that it was not necessary to record an impairment loss at the end of 2003, in part because the issuer contended that, absent the power supply shortage, the facility could operate at full capacity. The Firm's work papers included issuer-generated support for the determination not to record an impairment loss, but that support did not include detailed calculations of the estimated future cash flows or probability-weighted cash flows, nor did it address when, or if, the plant would be able to return to near capacity. Such analyses, or other detailed information addressing the value of the plant, would be necessary for the Firm to perform an appropriate evaluation

of management's assertion that it was not necessary to record an impairment loss at the end of 2003.<sup>12/</sup>

In addition, the Firm used a Firm specialist to assess the reasonableness of the issuer's recorded asbestos liability. The specialist's memorandum presented the conclusion that the issuer's recorded liability was not unreasonable; however, the exhibits attached to the memorandum indicated that the issuer's recorded liability was not within the range of values estimated by the Firm specialist. The work papers failed to evidence the Firm's evaluation of this difference or how the matter was resolved.

#### Issuer F

At December 31, 2003, an issuer maintained an allowance for loan losses ("ALL") to cover losses inherent in its loan portfolio. According to the Firm's planning document, the ALL presented specific identified risks related to inadequate or excessive reserves, as well as risks related to non-compliance with GAAP. Despite these identified risks, (1) the Firm did not test certain key assumptions and data used in the ALL calculation; (2) the control testing performed did not cover certain key controls over the issuer's process for accumulating historical data and developing the key assumptions used in the ALL calculation; and, (3) specific impairment reserve calculations were not tested for the sample of loans tested for impairment.

#### Issuer G

The Firm's evaluation of the issuer's ability to continue as a going concern was inadequate. The Firm's conclusion that the issuer had the ability to do so was based, in part, on the availability of the issuer's revolving credit facility. As a result, the Firm did not include a going-concern paragraph in its report on the issuer's 2003 financial statements. The issuer's access to the revolving credit facility, however, was dependent on the issuer's compliance with all the debt covenants, and the Firm failed to assess adequately the likelihood that the issuer would be able to meet one of these covenants, the 12-month trailing revenue covenant, for the first quarter of 2004. Specifically, although actual revenues for 11 of the 12 months to be used for measuring compliance

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<sup>12/</sup> In the first quarter of 2004, after the issuance of the 2003 financial statements, the issuer determined that the facility would be sold and recognized an impairment equal to approximately four percent of the 2003 net loss.

with this covenant were available before the end of field work, and these amounts appeared to indicate that revenues for the 12 months would fall short of the amount that would allow the issuer to meet the covenant at the end of the first quarter, the Firm did not specifically evaluate the issuer's ability to meet this covenant for the first quarter, nor did it evaluate how the issuer would be able to continue as a going concern should it not meet the covenant.<sup>13/</sup> In addition, the Firm did not obtain a management representation covering projections and assumptions related to the covenant.

#### Issuer H

The issuer emerged from bankruptcy during 2003 and applied fresh-start accounting in accordance with the American Institute of Certified Public Accountants ("AICPA") Statement of Position No. 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, under which the issuer's assets and liabilities were re-measured. The allocation of reorganization value to the issuer's three operating segments was determined by the issuer, with the assistance of a third-party appraisal firm, and resulted in the recording of goodwill. The issuer relied on a draft appraisal for the fair value allocation, as a final appraisal report had not been completed by the appraisal firm.

The Firm's work papers supporting the reorganization value allocation consisted only of spreadsheets that the issuer provided and did not include the draft appraisal report from the independent appraisal firm. In addition, the work papers did not include evidence that the Firm had performed sufficient procedures to address the completeness and accuracy of the key underlying data used in the allocation, or whether the Firm evaluated the significant assumptions and estimates management made in allocating fair value.<sup>14/</sup>

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<sup>13/</sup> The issuer failed to comply with the covenant in the first quarter of 2004.

<sup>14/</sup> After the 2003 year end but before the Firm issued its audit report – and only five months after the allocation date – the issuer signed a definitive agreement to sell one of its segments for more than twice the value that it had allocated to that business unit. As a consequence, the issuer recognized a significant gain on the sale of the segment.

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 seven 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; and commissions and contingent fees; (4) client acceptance and retention; (5) the Firm's internal inspection program; (6) practices for establishment and communication of audit policies, procedures and methodologies, including training; and (7) the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. audit clients. 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 Deloitte with applicable requirements and standards related to audits of issuers. This process included reviews of components of selected issuer audit engagements completed by Deloitte. 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 Deloitte's system of quality controls over audits. In addition, the inspection included reviews of the design of, and in some cases the application of procedures related to, certain functional areas of Deloitte that could be expected to influence audit quality.

#### **A. Review of Selected Audit Engagements**

The inspection team reviewed aspects of selected audits performed by Deloitte. The inspection team chose the engagements according to the Board's criteria. Deloitte 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 Deloitte'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, derivatives, income taxes, related party transactions, supervision of work performed by foreign affiliates, 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. For several engagements, the inspection team reviewed written communications between Deloitte and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

When the inspection team identified a potential issue, the inspection team spoke with members of the engagement team. If the inspection team was unable to resolve the issue through this discussion and any resultant review of additional work papers or

other documentation, the inspection team ordinarily requested the engagement team to consult with Deloitte's professional practice personnel, who include local office professional practice directors ("PPDs"), regional professional practice partners ("RPPDs") and members of the National Office professional practice group.

**B. Review of Seven Functional Areas**

The inspection team conducted the procedures related to the review of the seven functional areas primarily at Deloitte's National Office. With respect to six of the functional areas, the inspection team also conducted procedures at certain of Deloitte's practice offices. These procedures built on the foundation that was laid during the Board's limited inspection during 2003. The inspection team performed these procedures both to identify possible defects in Deloitte's system of quality controls and to update the Board's knowledge of Deloitte's policies and procedures in the seven functional areas. A more detailed description of the scope with respect to each of the seven functional areas follows.

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

The inspection team reviewed Deloitte's policies and procedures related to partner evaluation; partner compensation; nomination and admission of new partners; and disciplinary actions, 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 Deloitte.

The inspection team interviewed members of Deloitte's leadership at its 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 Deloitte 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 and partners who resigned or took early retirement.

## 2. Review of Independence Policies

The objectives of the inspection procedures in this area included evaluating Deloitte's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer clients; Deloitte's participation in 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 Deloitte's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed Deloitte's internal inspection program as it relates to monitoring compliance with Deloitte's independence policies and procedures; examined Deloitte's independence consultation process, which included reviewing a sample of independence consultations; and reviewed information concerning Deloitte's existing business ventures, alliances and arrangements, as well as Deloitte's process for establishing such enterprises. The inspection team also interviewed numerous National Office and practice office personnel regarding Deloitte's independence policies, practices and procedures.

For each of the engagements selected for review where Deloitte performed significant non-audit services, the inspection team reviewed relevant information to understand the types of services performed for the issuer, including whether any of the services involved contingent fee arrangements, and considered whether the fees for services provided were classified appropriately in the issuer's proxy statement. The inspection team also considered whether Deloitte entered into any business ventures, alliances, or arrangements with the issuer. For certain engagements, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

## 3. Review of Client Acceptance and Retention Policies

The primary objectives of the inspection procedures in this area were to evaluate whether Deloitte'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 Deloitte's policies, procedures and forms related to client acceptance and continuance;

evaluated documentation related to new clients and to clients that had recently changed auditors from Deloitte; and interviewed members of Deloitte'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 Deloitte'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.

#### 4. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of Deloitte's annual internal inspection program in enhancing audit quality, as well as to assess Deloitte'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 Deloitte's National Office related to its internal inspection program, documentation of the results of the current year's inspection program, and steps taken by Deloitte in response to those results. The inspection team also interviewed Deloitte'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 five practice offices. These procedures included evaluating the qualifications of Deloitte's inspectors, reading the inspectors' comments, reviewing the results of the inspectors' review of certain Firm-wide functional areas, and interviewing both area leadership and selected audit personnel concerning the internal inspection program. In addition, for a sample of the engagements that the internal inspectors reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the work papers, and discussed with Deloitte any significant differences in the results of the inspection team's review and that of Deloitte's internal inspectors.

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

The objectives of the inspection procedures in this area were to update the inspection team's understanding of Deloitte'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 changes in audit policies Deloitte has made since the 2003 limited inspection.

Toward those objectives, the inspection team reviewed documentation relating to Deloitte's method 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 Deloitte's processes for monitoring developments that could affect Deloitte's audit policies, procedures and methodologies.

6. Review of Policies Related to Foreign Affiliates

The inspection team performed procedures in this area to evaluate the processes Deloitte uses to ensure that audit work performed by its foreign affiliates on the foreign operations of U.S. issuers is effective and in accordance with standards established by the Board. The inspection team did not inspect the audit work of foreign affiliates; rather, the inspection procedures in this area were limited to the supervision and control exercised by the U.S. engagement team over such work.

To accomplish this objective, the inspection team reviewed Deloitte's policies and procedures related to its supervision and control of work performed by foreign affiliates on the foreign operations of U.S. issuer clients; analyzed audit guidance related to planning and administering multi-location engagements; and reviewed available information relating to the most recent foreign affiliated firms' internal inspections. In addition, the inspection team interviewed members of Deloitte's leadership with responsibility for oversight of the work performed by foreign affiliates on foreign operations of U.S. issuer clients. Finally, with respect to a sample of engagements selected from the engagements chosen for review, the inspection team reviewed the U.S. engagement teams' supervision and control procedures concerning the audit work performed by Deloitte's foreign affiliates.

7. Tone at the Top

The primary objective of the review of Deloitte's "tone at the top" was to assess whether actions and communications by Deloitte's leadership 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 Deloitte's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at Deloitte's National Office. Such information included Deloitte's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, Deloitte staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; descriptions of Deloitte's financial structure and business plan; and agendas and minutes of Deloitte's board of directors. In addition, the inspection team interviewed 19 members of Deloitte's leadership team.

The inspection team conducted interviews at 24 of Deloitte's practice offices to obtain perspectives on communications from Deloitte's leadership relating to audit quality and tone at the top. The inspection team interviewed members of the leadership at each of these offices, as well as certain audit partners and senior managers assigned to engagements that were reviewed. In addition, the inspection team conducted two focus group meetings in 12 of the practice 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 groups meetings consisted of audit senior managers and audit managers, and the other was composed of audit senior accountants and audit staff.

## **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.



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September 14, 2005

Mr. George Diacont  
Director  
Division of Registration and Inspections  
Public Company Accounting Oversight Board  
1666 K Street NW  
Washington, DC 20006

Re: Deloitte & Touche LLP

Dear Mr. Diacont:

Deloitte & Touche LLP ("D&T") is pleased to submit its response to the Public Company Accounting Oversight Board's (the "Board") August 15, 2005 draft of its Report on 2004 Inspection of Deloitte & Touche LLP (the "Draft Report"). We are supportive of the inspection process and believe the Board's comments and observations enhance the ability to achieve our shared objective of improving audit quality.

D&T is committed to the highest standards of audit quality. We continually monitor the systems and processes for our audit practice, including quality control, and make changes to methodologies, policies, and procedures when we identify improvements that could enhance audit quality. As we did with respect to the Board's August 26, 2004 Report on Limited Inspection of Deloitte & Touche LLP (the "2003 Report"), we will thoroughly consider the Board's comments and concerns addressed in the Draft Report (including any revisions that might be made before the report is formally issued), assess whether we have already initiated actions that address those concerns, and consider whether additional actions are necessary.

We have taken appropriate action to address the matters identified by the Board's inspection team for each of the instances described in Part I of the Draft Report. We have considered whether it was necessary to perform additional procedures in accordance with 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*. As noted in the Draft Report, in four of the instances the applicable issuer has restated its financial statements to correct accounting errors or disclosure deficiencies.

In addition, we have the following specific comments on Part I of the Draft Report:

In its comments regarding Issuer D, the Board states "The firm inappropriately relied on certain controls, in particular general computer controls, automated application controls and security controls, without performing sufficient testing to support reliance on those controls." We respectfully disagree. Testing of internal controls, including general computer controls, has been performed by the engagement team under a rotation basis under applicable professional standards since the inception of D&T's auditor relationship with the Company, a period covering four audits. The current year audit engagement team considered numerous factors, including the history of controls testing and related results of such repeated tests at this ongoing client, inherent and specific risks identified during prior audit work

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performed by the engagement team, procedures performed by the engagement team during each of the quarterly reviews regarding updating the engagement team's understanding of the Company's internal controls and any changes therein, current risks to the data processing environment identified during the annual update discussions with the Company's data processing department, and the risk identification and testing approach applied to the Company's specific technical environment. Discussions between the Board's inspection team and the engagement team did not address these factors. When considering the foregoing in combination with D&T's cumulative knowledge of the Company's data processing technical environment, our overall assessment of the control environment which considers the evidence obtained for all controls assessed, and professional judgment applied to control concerns noted during the course of the audit, we believe that the nature, timing and extent of testing performed appropriately supports a control reliance strategy. The working papers have been supplemented by the engagement team with currently dated documentation to more clearly describe the procedures performed, evidence obtained, and conclusions reached.

Regarding Issuer G, the Board states "The Firm inadequately evaluated the issuer's ability to continue as a going concern." We respectfully disagree. The engagement team's consideration of, consultations about, and conclusions reached regarding the issuer's ability to continue as a going concern were thorough and were documented in the working papers.

In footnote 14 to the comments on Issuer H, the Board states "The Firm's National Office was not formally consulted with respect to the appropriateness of the recognition of the gain on sale prior to the issuance of the Firm's audit report." While accurate, this statement implies that a formal consultation was required, and we respectfully disagree. The engagement team researched the professional literature and previous positions taken by the Firm in similar circumstances and concluded that the issuer's treatment was consistent with those positions and appropriate under the circumstances. We support the engagement team's judgment that a formal National Office consultation was not necessary under the circumstances.

With respect to other matters discussed in Part I of the Draft Report that relate to adequacy of documentation, where we considered necessary, currently dated documentation has been added to the working papers to more clearly describe the procedures performed, evidence obtained, and conclusions reached.

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We are available to the Board and its staff to discuss our comments in further detail. Please contact Robert J. Kueppers at 203.761.3579, or Thomas G. Godbout, Jr. at 203.761.3452, with any questions.

Sincerely,

