



1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

Report on
2004 Inspection of KPMG LLP
Issued by the
Public Company Accounting Oversight Board
September 29, 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**

PCAOB RELEASE NO. 104-2005-088

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 KPMG LLP

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

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

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

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

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

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") performed an inspection of KPMG from June 2004 to October 2004. The inspection team performed field work at KPMG's National Office and at 11 of its 90 practice offices. Appendix B to this report provides a 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.^{3/} It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

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

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

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,^{4/} and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers. In some instances in which the inspection team identified GAAP departures, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.^{5/}

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

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

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

more than one such failure. The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis (without identifying the issuers).^{6/}

Issuer A

In this audit, the Firm failed to identify various departures from GAAP that it should have identified and addressed before issuing its audit report.^{7/} First, the issuer accounted for a sale-leaseback transaction using normal sale-leaseback accounting, despite the presence of conditions that made such accounting inappropriate under Statement of Financial Accounting Standards ("SFAS") No. 98, *Accounting for Leases*. As a result, the assets and the debt attributable to the sale-leaseback properties were not reflected in the issuer's balance sheet, as they should have been, and the issuer recorded a deferred gain that it should not have recorded. The Firm's documented analysis of this transaction outlined general accounting considerations under SFAS 98, but did not reference the contractual terms that had the effect of precluding normal sale-leaseback accounting.^{8/} These terms – guarantees, letters of credit and indemnification arrangements – also were not disclosed in the footnotes to the issuer's financial statements.

In addition, the issuer failed to disclose in its financial statements (1) certain lease arrangements; (2) information concerning an impaired asset and the issuer's method for determining the fair value of the asset; and (3) information concerning related party transactions between the issuer and entities in which its chairman and chief executive officer had an ownership interest. Omitting these disclosures was inconsistent with, respectively, SFAS No. 13, *Accounting for Leases*; SFAS No. 144,

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

^{7/} This issuer has restated certain of its financial statements to make changes relating to each of the matters described here.

^{8/} Relevant contracts were not included in the Firm's work papers. Copies of these documents, or abstracts of them, should have been included in the work papers.

Accounting for the Impairment or Disposal of Long-Lived Assets; and SFAS No. 57, *Related Party Disclosures*.

Also, on or about the same date as the sale-leaseback transaction described above, the issuer and another party were involved in a separate transaction in which that other party provided financing for the issuer's purchase of a substantial asset from a related party of the issuer. This caused the inspection team to raise questions with the Firm about possible side agreements and undisclosed guarantees related to lease transactions. As a result, the Firm performed additional analyses of leases and determined that (1) certain leases that were accounted for as operating leases should instead be accounted for as capital leases, and (2) the accounting for certain operating leases with rent escalators should be changed to accrue total rent expense on a straight-line basis over the lease term rather than recording actual rent paid under these leases.

Issuers B and C

Approximately one-third of the cash and cash equivalents reported by one issuer, and approximately 43 percent of the cash and cash equivalents reported by another issuer, were invested in securities that were not appropriate for classification as cash or cash equivalents under SFAS No. 95, *Statement of Cash Flows*. In each case, the Firm should have identified and addressed the incorrect accounting.^{9/}

Issuer D

In this audit, the inspection team noted a GAAP departure and several deficiencies in the application of PCAOB standards.

First, the issuer accounted for certain derivative instruments using the normal purchases and normal sales ("NPNS") exception under SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* ("SFAS 133"), which requires the use of accrual accounting instead of fair value accounting. The issuer did not, however, satisfy the conditions for using the NPNS exception, because the issuer failed to comply with the specific requirement in SFAS 133 to document sufficiently, on a contemporaneous

^{9/} The issuers have reclassified certain of their financial statements prospectively to make changes relating to the matters described here.

basis, a determination that the derivative instruments met all of the requirements set forth under the NPNS exception of SFAS 133. Accordingly, the issuer should not have used the NPNS exception and should not have used accrual accounting for these derivatives. Had the issuer not used accrual accounting for these derivatives (and corrected certain other errors in its financial statements), its reported net income would have been 18 percent and two percent higher in 2002 and 2003, respectively. The Firm noted during both the 2002 and the 2003 audits that the issuer did not develop the required documentation, but the Firm failed to appropriately address the issuer's improper accounting for the derivatives.

On the same audit, instead of following the typical practice of using a percentage of pre-tax income as the measure of materiality for designing audit procedures to obtain sufficient competent evidential matter ("planning materiality"), the Firm used a percentage of total assets (reduced for certain intangible assets). This resulted in a higher planning materiality than if the maximum percentage of pre-tax income allowed for by Firm policy had been used. The Firm then used ten percent of planning materiality, a relatively high percentage, as the threshold (the "posting threshold") below which an error would be treated as inconsequential and thus would not be posted to the Summary of Unadjusted Audit Differences ("SUAD").^{10/} Further, for errors in the 2003 balance sheet that originated in prior years, the Firm decided to use a different posting threshold that was based not on pre-tax income for those years but instead on equity at the end of 2003. This equity posting threshold was approximately 13 times the posting threshold used for errors that arose in 2003.^{11/} Also, this posting threshold was approximately 18 times the posting threshold that the Firm had used for errors that arose in 2002 when it audited the issuer's financial statements for that year. As a result of applying these thresholds, the Firm failed to include on the 2002 and 2003 SUADs several uncorrected accounting errors, and thus those errors were not evaluated individually and in the aggregate for materiality. Including errors identified either in the audit for 2002 or the audit for 2003, those uncorrected errors omitted from the SUAD included –

^{10/} The SUAD is a schedule of uncorrected errors to be communicated to the audit committee, included in the management representation letter, and evaluated individually and in the aggregate for materiality.

^{11/} The Firm used the same approach in 2002, the first year it audited this issuer.

- A workers' compensation under-accrual that, if corrected in any of the years from 2001 through 2003, would have represented between seven and 10 percent of net income for the year in question;
- An overstatement of a liability at the end of 2002 for stock appreciation rights that, if corrected in the year it was identified, could have had an effect on quarterly income ranging from approximately one percent to nearly 80 percent;
- An understatement of customer rebates in 2002 and prior years;^{12/} and
- An overcapitalization of interest from 2002 that was discovered in 2003.

In addition, the Firm did not evaluate thoroughly other known or likely errors:

- In 2002, the issuer wrote off certain deferred costs that it had inappropriately capitalized, and undertook to investigate the remainder of these deferred costs. Despite actively searching for a buyer, the issuer had not been able to sell the technology to which the deferred costs relate. While the Firm's work papers noted that it appeared that some of the remaining costs should not have been deferred, the Firm did not evaluate to what extent the costs should not have been capitalized, nor did it propose an audit adjustment related to this issue.
- The issuer serviced a note that was prepaid several years before the audits under inspection. At the time of prepayment, the issuer recorded a payable to the owner of the note and thereafter, as the issuer continued to make interest payments to the note owner, reduced this payable rather than recording interest expense. The Firm's work papers acknowledged that if this practice continued, there would be a future "income statement

^{12/} This error was recorded in the financial statements in the quarter in which it was discovered, as was the error in stock appreciation rights, which had been discovered earlier. The Firm evaluated the effect of the two errors on a net basis, and determined that the net effect was below posting thresholds (although the errors individually were not).

hit," but the Firm did not include this error on its SUAD, nor did it assess the propriety of the issuer retaining the prepaid principal.

- In 2003, the Firm noted several errors related to revenue recognition matters, and projected each error to the class of transactions to which it related, with the exception of the error related to returns and allowances. This error was not posted to the SUAD, and when the Firm accumulated the effects of all the other revenue recognition errors, it determined that the total effect of these errors was just below the threshold for posting to the SUAD.

In some of the above-noted situations, the Firm combined the effects of known errors so that the net effect was less than the posting thresholds for the SUAD. In addition, the Firm apparently did not reconsider its assessment of risk and materiality or revisit its audit scope in light of the known and likely errors, did not give sufficient consideration to the qualitative nature of the uncorrected errors and did not reconsider its fraud risk assessment related to an issuer that is unwilling to correct known errors.

In addition, the Firm's work papers did not address whether the issuer's investments in marketable securities or U.S. government securities were appropriately classified, and the Firm did not test the issuer's evaluation of a financial derivative, even though the issuer used different inputs for that evaluation than the forward price curve would indicate.

Finally, the Firm inappropriately relied on the IT general controls at a service organization that managed and operated the infrastructure for the issuer's centralized general ledger system, without sufficient testing of those controls. The Firm purported to rely on work performed by the issuer's internal audit department ("IAD"), both as to IT general controls at the service organization and as to IT general controls over the issuer's six data centers, but the Firm's summaries of the IAD reports did not sufficiently describe the IAD procedures or test results that would indicate that IAD assessed or tested those controls. While the Firm tested selected application controls, it did not test all the accounting applications that were supported by the general controls at the service organization or the six data centers.

Issuer E

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

The issuer received cash proceeds from the sale of certain investments in 2003, based on agreements dated in 2003, and did not recognize the associated gains until 2004. The Firm failed to perform an analysis to determine whether deferral of the gains to 2004 was appropriate.

The Firm assessed the risk of significant misstatement ("ROSM") as "high" for expenses, but, with the exception of procedures relating to depreciation, interest expense, and restructuring charges, failed to perform sufficient substantive procedures on expense balances.

The Firm concluded that certain accrued liabilities were overstated but did not include these errors on the SUAD even though, in the aggregate, the errors exceeded the Firm's planning materiality threshold for the audit. In addition, the issuer reduced certain accruals during the first quarter of 2004 by an aggregate amount that equaled the 2003 planning materiality threshold, but the Firm's work papers did not include the rationale for the reduction.

The issuer's allowance for doubtful accounts at December 31, 2003 represented 16.7 percent of accounts receivable and approximately five times 2003 write-offs. In the first quarter of 2004, the issuer reversed 16.2 percent of this allowance into income, even though its accounts receivable balance had increased by 60.4 percent. The Firm's work papers failed to include sufficient documentation concerning, or reflect sufficient explanation of, the issuer's allowance.

The Firm failed to assess, or failed to include in its work papers the audit evidence relevant to assessing, whether the overstatement of accruals and the accounts receivable reserve discussed above indicated a bias in management's estimates that could result in material misstatement due to fraud. The Firm failed to do so even though it assessed the fraud risk for these items as "high."

The Firm used an inappropriately high threshold for posting uncorrected errors to the SUAD. The posting threshold affecting net income equaled 67 percent of planning materiality.

The Firm failed to document a rationale for the appropriateness of the issuer's expensing of certain costs incurred prior to the receipt of a signed contract. In addition, the Firm failed to identify or appropriately address the issuer's failure to disclose its accounting policy regarding such costs.

Issuer F

In this audit also, the Firm failed in several respects to obtain sufficient competent evidential matter to support its audit opinion –

The Firm failed to audit the issuer's goodwill impairment analysis.

The Firm's auditing of certain segment data contained in the issuer's financial statements was limited to comparing the segment data to management reports. Because of limitations in the Firm's testing of the system that generated the management reports, however, mere comparison of the segment data to those reports was insufficient to audit the segment data. Further, the work papers do not document the rationale for aggregating two businesses into a single reportable segment.

The Firm had assessed the ROSM as "moderate" for most significant accounts -- including revenue, receivables, inventory, and accruals -- but the Firm inappropriately reduced ROSM to "low" during final audit procedures. As a result, the Firm performed insufficient audit work on those accounts.

The issuer used a service organization for payroll services, and the Firm placed reliance on the controls at the service organization with respect to vacation expense and accrual testing. The Firm, however, had not obtained an understanding of the internal controls at the service organization through its own assessment, nor had it obtained an auditor's report on the service organization prepared in accordance with AU 324, *Service Organizations*. Thus, the Firm should not have relied on the controls at the service organization.

The work papers did not document the Firm's threshold for posting errors to the SUAD, and several uncorrected errors noted in the work papers were not posted to the SUAD, were not evaluated for materiality in the aggregate, and were not included in the management representation letter.

There was also no evidence in the work papers to indicate that the Firm (1) audited the income tax provision beyond comparing the issuer's tax schedules to the financial statement disclosures;^{13/} (2) obtained testing results that supported the Firm's assessment of control risk as below the maximum; (3) considered the effects of distributor agreements on revenue recognition, even though sales to third-party distributors contributed 64 percent of net sales in 2003; or (4) performed required journal entry testing or look-back testing of significant estimates.

Issuer G

In this audit, the Firm relied on the effectiveness of issuer controls surrounding the revenue cycle, but the Firm's only testing of those controls was with respect to a period after the year under audit. The Firm therefore lacked a sufficient basis for the reliance it placed on those controls for the year under audit. In addition, in determining the sample size for accounts receivable confirmations, the Firm assessed ROSM as "low" based in part on the level of control testing the Firm had anticipated while planning the audit. Because that control testing did not provide a basis for reliance on the controls, however, the assessment of ROSM as "low" was not appropriate, and the sample size was smaller than it should have been.

In addition, in auditing the issuer's revenue and expenses, the Firm (1) failed to consider contracts and the effects their terms may have on revenue recognition; (2) failed to perform procedures on the revenue recognition trigger process for a segment of revenue that represented approximately 40 percent of total revenues; (3) performed a substantive analytical procedure using expectations based on statistics the validity of which the Firm did not test; (4) failed to perform a step in the audit program to test the underlying data supporting a portion of deferred revenue; and (5) tested certain expense and accrual balances by comparing various reports to the payroll system without having tested the payroll system and thus without any basis to rely on the reports.

Separately, in auditing the issuer's self-insurance liability, the Firm relied on summary claims data obtained from the issuer's third-party processor, but no service auditor's report was available from the processor. In the absence of a service auditor's

^{13/} In fact, the tax provision review memorandum was dated seven months after the audit opinion date and contained no signatures.

report, the Firm should have performed additional audit procedures on the processor's claims data but failed to do so.

Issuer H

In auditing the fair value assigned to investments by the issuer, the Firm failed to review all the information considered by the issuer in determining the fair value and failed to determine whether the issuer's valuation method conformed to the issuer's stated policy. In addition, the Firm failed to identify the issuer's inappropriate allocation adjustments that resulted in some of the fair value amounts reported on a required supplemental schedule of investments being incorrect.

Issuer I

In this audit, the Firm tested the operating effectiveness of the controls over certain processes as of interim testing dates, but the work papers do not evidence any procedures to roll forward these tests to the balance sheet date, and the Firm therefore lacked a reasonable basis for extending its conclusions to the balance sheet date.

In addition, in auditing the issuer's pricing of its securities, the Firm relied on a financial pricing model that the issuer used, but the Firm failed to test the data inputs to the model and failed to document a basis for reliance.

The Firm also performed a price test intended to be a dual-purpose test of both controls and account balances, but the Firm failed to comply with its own policies concerning calculating sample size, and accordingly, tested a smaller sample than it should have.

Issuer J

In this case, the issuer had performed, using an outside company, an impairment analysis concerning its operations in a country where, because of a tax imposed, the issuer had curtailed its operations and had submitted a claim to the country's government for lost profits and other damages. In its initial impairment analysis, the issuer assumed that the tax would be repealed in 2004, and that, in the next year, its operations would return to the levels in existence before the imposition of the tax. As the Firm concluded that the assumptions underlying this initial valuation produced aggressive cash flows, the issuer obtained a revised valuation, which increased the

discount rate and assumed that the issuer would receive a substantial portion of its claim. Without any documented evidence of appropriate audit scrutiny, and despite indications that this assumption was not the most probable outcome, the Firm inappropriately accepted the assumption concerning recovery on the claim. In addition, without considering various alternative scenarios (such as repeal of the tax in a later year) and applying probability percentages, the Firm inappropriately accepted the issuer's assumption concerning repeal of the tax in 2004 and the timing of the resumption of full operations following a repeal of the tax.

Issuer K

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

In auditing the issuer's oil and gas reserve estimates, the Firm compared the prior year's reserve estimates to the current year's production for the issuer's properties in one geographic area, but it did not do so for the properties in the geographic area that accounted for the majority of the issuer's domestic production. Separately, the Firm failed to document its understanding of the issuer's method for selecting the reserves that the issuer included in its partial assessment of reserves. Further, the reserve estimates were prepared by engineers who are employees of the issuer. The firm failed to perform any procedures to address the objectivity of the issuer's reserve engineers.

In addition, based substantially on its testing of the issuer's controls over the granting of credit, the Firm concluded that it did not need to confirm accounts receivable. In assessing the controls, the Firm did not document how the issuer addressed major credit overages (although it knew such events occurred), nor did it address in the work papers the nature and effect of certain netting agreements. Further, the Firm failed to consider appropriately the aggregate amount by which receivables from the issuer's customers exceeded those customers' credit limits with the issuer, and so failed to determine whether there was a material exposure in the valuation of accounts receivable. In any event, the existence of credit controls is not a sufficient substitute for testing the existence and accuracy of accounts receivable through the use of confirmations or other substantive testing.

In addition, in analyzing whether the issuer's sale of receivables under a revolving securitization program met the accounting criteria for a sale, the Firm inappropriately relied on a legal opinion obtained by the issuer that was restricted to the

use of certain parties. Although the Firm was not one of those parties, the Firm did not obtain a waiver of those use restrictions. Without such a waiver, the Firm should not have relied on the legal opinion as audit evidence.

Issuer L

In this audit, the Firm assessed ROSM in one area as "low" without having performed sufficient tests of controls to support that assessment. The Firm's controls testing relied on system-generated reports, without the Firm having tested the underlying data, general IT controls, or related system application controls to gain assurance that the reports were accurate and complete.

Issuer M

In this audit, the Firm assessed the ROSM risk for revenue as below the maximum, without having performed sufficient tests of the issuer's general computer controls to support that assessment. The issuer's information system processing environment relies heavily on processing of orders through an electronic data interchange that links with an enterprise system that interfaces with a separate accounts receivable system. The Firm failed to perform tests of the electronic data interchange system or the financial statement system. In addition, for the controls that the Firm did test, the work papers did not provide evidence that the systems tested and relied upon during the audit continued to operate effectively throughout the period of intended reliance.

Issuer N

In auditing the issuer's leases, the Firm failed to include any leases that contained rental step-down clauses, which provide for a reduction in the annual base rent if the renewal option is exercised by the lessee and which affect the calculation of income to be recognized over the lease term.

Issuer O

In evaluating the issuer's assertion regarding the fair value of marketable securities, the Firm failed to perform procedures to assess whether the fair value included on confirmations from third parties was determined in a manner consistent with GAAP.

Issuer P

In this audit, the work papers did not include any evidence that the Firm assessed whether the issuer's presentation of a single reportable segment was consistent with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, in circumstances where the issuer sold products through four distribution channels and the issuer's internal financial statements included a full income statement for each distribution channel.

Issuer Q

The Firm audited certain accounts receivable balances at an interim date, but did not audit the issuer's analysis of the roll-forward of these balances to the year end.

Issuer R

In this audit, the Firm did not send confirmations to third parties to verify the existence of unsettled purchases of securities at year end.

Issuer S

In this audit, the Firm lacked sufficient basis for the reliance it placed on the controls at a service organization, because no service auditor's report was available for the year being audited and the Firm did not perform the procedures necessary for it to rely on those controls in the absence of a service auditor's report. The Firm's reliance on a service auditor's report from a previous year was not an appropriate substitute.

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

1. Review of Selected Audit Engagements

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

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenues, reserves or estimated liabilities, 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 each engagement, the inspection team reviewed written communications between KPMG 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, it discussed the issue with members of the audit engagement team and representatives of KPMG's Department of Professional Practice ("DPP"). If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other

documentation, the inspection team ordinarily requested the engagement team to consult with DPP in its National Office.

2. Review of Seven Functional Areas

The inspection team conducted the procedures related to the review of the seven functional areas primarily at KPMG's National Office. With respect to six of the functional areas, the inspection team also conducted procedures at certain of the Firm'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 KPMG's system of quality controls and to update the Board's knowledge of the Firm'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.

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

The inspection team reviewed the Firm'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 the Firm.

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

b. Review of Independence Policies

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

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

c. Review of Client Acceptance and Retention Policies

The primary objectives of the inspection procedures in this area were to evaluate whether the Firm'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 KPMG'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 KPMG; and interviewed members of the Firm'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 Firm policies; interviewed the audit partners and managers on these engagements concerning the reasons for continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks; and assessed whether the audit planning documentation incorporated the specific actions, if any, developed in response to any identified risks.

d. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of KPMG's annual internal inspection program in enhancing audit quality, as well as to assess the Firm's compliance with the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance and forms at KPMG's national offices related to its internal inspection program, documentation of the results of the current year's inspection program, and steps taken by the Firm in response to those results. The inspection team also interviewed KPMG'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 by performing field work in six practice offices where the Firm conducted internal inspections. These procedures included evaluating the qualifications of the Firm'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 had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with KPMG any significant differences in the results of the inspection team's review and that of the Firm's internal inspectors.

e. 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 the Firm'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 policy the Firm has made since the 2003 limited inspection.

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

f. Review of Policies Related to Foreign Affiliates

The inspection team performed procedures in this area to evaluate the processes KPMG 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 KPMG'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 and analyzed audit guidance related to planning and administering multi-location engagements. In addition, the inspection team interviewed members of the Firm'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 team's supervision and control procedures concerning the audit work performed by the Firm's foreign affiliates.

g. Review of Tone at the Top

The primary objective of the review of KPMG's "tone at the top" was to assess whether actions and communications by the Firm'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 the Firm's performance of

audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at KPMG's National Office. Such information included KPMG's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, KPMG's staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; descriptions of the Firm's financial structure and business plan; and agendas and minutes of the Firm's board of directors. In addition, the inspection team interviewed 22 members of KPMG's leadership team.

The inspection team conducted interviews at 11 of the Firm's practice offices to obtain perspectives on communications from the Firm'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 eight focus group meetings in these 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. Four of these focus groups meetings consisted of audit senior managers and audit managers, and four were 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.



345 Park Avenue
New York, N.Y. 10154

Telephone 212-758-9700
Fax 212-872-3001

September 12, 2005

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

Re: Response to Public Company Accounting Oversight Board (PCAOB) Report of
2004 Inspection of KPMG LLP

Mr. Diacont:

Thank you for the opportunity to review the PCAOB's Report on the 2004 Inspection of KPMG LLP dated August 11, 2005. We believe the PCAOB's inspection process is a valuable means of evaluating audit performance and quality controls and that your recommendations will meet our shared goal of serving the capital markets with high quality audits.

KPMG is committed to improvement in its audit quality and your inspection comments contribute directly to that process. To that end, we will continue to enhance our audit methodology as well as our engagement documentation and execution.

We at KPMG acknowledge the dedicated performance of the PCAOB staff and thank them for their efforts to support our mutual objective of improving audit quality. We appreciate the constructive dialogue and consider it essential in the process of improving our system of quality controls. We would also like to recognize the people of KPMG and the effort they expend to perform high quality audits in a challenging environment.

The comments that follow respond to *Part I – Inspection Procedures and Certain Observations* of your 2004 Inspection Report. The PCAOB's inspection of each of the engagements selected was performed thoroughly and was based upon the PCAOB staff's assessment of audit risk and financial statement materiality. While we may have differing views on specific issues relative to the scope of audit procedures and documentation necessary to comply with applicable professional standards, we recognize that judgments are involved in both the performance of an audit and the subsequent inspection process, and view the PCAOB's comments as positive and helpful.

We accept the PCAOB's findings in the Report. We agree that one engagement, identified as Issuer A, had deficiencies that represent departures from both PCAOB standards and KPMG's quality control procedures. In accordance with PCAOB professional standards and our policies and procedures, KPMG undertook a complete review of this engagement and discussed all identified GAAP departures with our client and its audit committee. Our client subsequently determined that it was appropriate to restate its financial statements and KPMG, after completing additional audit procedures, reissued its auditors' report on the restated financial statements. We take such situations seriously and have responded to all deficiencies in the engagement, including increased monitoring of members of the engagement team.



KPMG, LLP, a U.S. limited liability partnership, is the U.S.
member firm of KPMG International, a Swiss cooperative.



Mr. George H. Diacont
Public Company Accounting Oversight Board
September 12, 2005
Page 2

With respect to the other findings identified in the Report, consistent with PCAOB professional standards and KPMG policies and procedures, we have addressed the deficiencies identified by the PCAOB staff and performed either additional audit procedures or improved the documentation in the audit files. As a result of these actions, we have concluded that no new facts came to our attention that caused us to believe that our previously issued auditors' reports should be withdrawn. We have shared our conclusions with the PCAOB staff, including all improvements made to audit files.

* * *

In the past several years, we have further strengthened our commitment to quality, made fundamental changes to our business and landmark improvements to our risk management structure; and put cultural and governance reforms into effect that reflect the highest ethical standards. We have taken these actions mindful of our responsibility to the capital markets; respectful and grateful for the trust our clients place in us; and dedicated to the highest standards of excellence and professionalism.

In closing, the professionals of KPMG understand the importance of strengthening our firm and the profession as we work with the PCAOB to improve audit quality. Questions regarding the letter should be directed to Michael J. Baum, (212) 909-5604, mjbaum@kpmg.com.

Very truly yours,

KPMG LLP