

**Report on**  
**2004 Inspection of PricewaterhouseCoopers LLP**

Issued by the  
**Public Company Accounting Oversight Board**

November 17, 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 PRICEWATERHOUSECOOPERS LLP**

In 2004, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted an inspection of PricewaterhouseCoopers LLP ("PwC" 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 PwC from May 2004 to January 2005. The inspection team performed field work at PwC's National Office and at 25 of its approximately 65 U.S. 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.<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.

#### **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

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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 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,<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 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

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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 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.

are described below (without identifying the issuers).<sup>6/</sup> The deficiencies are discussed here on an audit-by-audit basis, with the exception of certain types of deficiencies that were observed to recur in multiple audits and are therefore grouped together.

#### Deficiencies in Auditing Receivables (Nine Audits)

PCAOB standard AU 330, *The Confirmation Process*, sets out a presumption that the auditor will request the confirmation of accounts receivable during an audit unless certain specified conditions are present. When the auditor does not request confirmation of accounts receivable, the auditor should apply alternative procedures to obtain the evidence necessary to reduce audit risk to an acceptably low level. On the audits of seven issuers where the Firm did not request that customers confirm the existence of accounts receivable,<sup>7/</sup> the Firm performed alternative procedures; however, in each instance the Firm either failed to obtain, or failed to document in the work papers that it had obtained, sufficient competent evidential matter regarding the existence of accounts receivable to support its audit opinion. Some of these seven audits included more than one deficiency relating to alternative procedures. The deficiencies included the following:

- In four audits, the Firm tested a sample of subsequent cash receipts that purportedly were received in payment of the accounts receivable that were recorded as of a specified date. In each case, the sample size was inadequate for the testing required because the Firm used the wrong method of sampling. (Issuers A, B, C and D)
- In three audits, the Firm did not test, or failed to include evidence in the work papers that it had tested, the accounts receivable that had not been paid. (Issuers A, C and E)

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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> One of the audits involved the accounts receivable of a reportable segment as opposed to all of the issuer's accounts receivable.

- In one audit, the Firm did not test a material difference between a supporting schedule used in the alternative procedures and the general ledger. (Issuer B)
- In two audits, the Firm used analytical procedures as alternative procedures. The Firm, however, did not perform certain required steps, such as developing expectations and defining a significant difference or threshold, when performing the analytical procedures. (Issuers F and G)

The inspection team also observed other types of audit deficiencies related to receivables in some of these audits, as well as in two additional audits where the deficiencies resulted in the Firm failing to obtain, or failing to document in the work papers that it had obtained, sufficient competent evidential matter to support its audit opinion. Those deficiencies included the following:

- On two audits, the Firm failed to perform sufficient procedures on the activity in accounts receivable between the interim date as of which the alternative procedures were performed and year end. In both instances, the Firm only performed high-level analytical procedures to test the activity during this period.<sup>8/</sup> (Issuers A and H)
- On one audit, the Firm requested confirmations for a sample of loans that the issuer serviced. For the loans for which there were no responses, the Firm compared the information on the requests to the system from which the loans had been selected rather than comparing the information to the underlying documents. (Issuer I)
- On one audit, the Firm also failed to test, or failed to include evidence in the work papers that it had tested, the note receivable that arose when the issuer transferred certain receivables, or the underlying receivables. (Issuer E)

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<sup>8/</sup> Following the inspection team's discussion with the Firm of these matters, the Firm performed additional audit procedures and identified a misstatement in the financial statements of one of these issuers relating to the timing of the issuer's recognition of revenue. The issuer subsequently restated its financial statements.

- On one audit, the Firm's documented reason for not requesting confirmations of accounts receivable was not one of the acceptable conditions for not performing this procedure, and on another audit, the Firm failed to document, as required by PCAOB standards, how it overcame the presumption that the auditor will request the confirmation of accounts receivable. (Issuers B and C)

#### Deficiencies in Testing of Internal Controls Relied Upon by the Firm (10 Audits)

PCAOB standards require the auditor to test internal controls before relying on them for the purpose of designing and performing the substantive audit procedures. In 13 instances involving the audits of 10 issuers, the Firm failed to test, or failed to perform sufficient tests of, controls that the Firm relied on in designing and performing its substantive audit procedures. The instances included the following:

- The Firm relied on information technology ("IT") application controls that had not been tested for several years. (Issuers J and K)
- The Firm did not sufficiently address the effects of deficiencies in IT program access controls, change-management controls, or application controls. (Issuers D, G, and M)
- The Firm relied on change-management controls that had been tested only for the first half of the year without performing appropriate updating procedures. (Issuer J)
- The Firm relied on IT system-generated data without testing the IT general computer and/or application controls. (Issuers D, N, O, P, and Q)
- The Firm tested controls using samples that were smaller than necessary to support reliance on the types of controls being tested. (Issuers P and R)

#### Issuer S

The Firm was aware that an issuer had not recorded a deferred tax liability for a portion of its accumulated foreign currency translation adjustment that was associated

with the unremitted earnings from its non-U.S. subsidiaries that were included in other comprehensive income. Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes*, requires that a deferred tax liability be recorded in this situation. The Firm should have addressed the incorrect accounting.<sup>9/</sup>

#### Issuer V

The Firm failed to evaluate the appropriateness of an issuer's classification of certain investments as cash equivalents. The issuer subsequently determined that approximately 89 percent of its reported cash and cash equivalents were invested in securities that were not appropriate for classification as cash or cash equivalents under SFAS No. 95, *Statement of Cash Flows*.<sup>10/</sup>

#### Issuer R

On one audit, the Firm failed to evaluate whether certain contracts to purchase a commodity constituted derivatives.

#### Issuer W

The issuer entered into option and contingent purchase contracts to acquire land. The aggregate value of the option contracts, as documented in the work papers, was approximately 20 percent of the issuer's total assets. The issuer analyzed the contracts and concluded that it was not the primary beneficiary of the contracts, and therefore, it was not required to consolidate them under FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*. The Firm failed to evaluate, or failed to include evidence in the work papers that it had evaluated, the issuer's analysis.

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<sup>9/</sup> After the inspection field work, and at the same time that the issuer restated its financial statements to address other issues, the issuer restated its financial statements with respect to this matter.

<sup>10/</sup> After the inspection field work, and at the same time that the issuer restated its financial statements to address other issues, the issuer restated its financial statements with respect to this matter.

#### Issuer X

During the issuer's first quarter of fiscal 2005, it reached a settlement with a customer that it included in net sales and did not disclose. As a result of including the entire settlement amount in net sales, the issuer's net sales increased from the first fiscal quarter of 2004 to the first fiscal quarter of 2005. If the entire settlement had been omitted from net sales, net sales would have decreased. The Firm failed to consider the appropriateness of including the settlement in net sales and not disclosing that fact.<sup>11/</sup>

#### Issuer Y

On this audit, the Firm recalculated the issuer's allowance for doubtful accounts based upon the issuer's methodology. There is no evidence in the work papers, however, that the Firm either tested the issuer's methodology or followed one of the other methods prescribed in AU 342, *Auditing Accounting Estimates*.

#### Issuer Z

On one audit, the Firm should have tested the derivatives in the issuer's trading portfolio (and the Firm's planning documentation indicated that the Firm would test them), but the Firm failed to do so.

#### Issuer I

On the audit of this issuer, the Firm represented that it relied on the work of internal audit related to the portion of the issuer's loan portfolio that is serviced by third parties; however, the Firm failed to perform, or failed to include evidence in the work papers that it had performed, the following:

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<sup>11/</sup> Following the inspection team's discussion with the Firm of these matters, the Firm performed additional audit procedures and concluded that 50 percent of the settlement belonged in net sales and the remainder belonged in other income, and the issuer disclosed the settlement in subsequent financial statements. Had only half of the settlement been included in net sales, reported net sales would have been approximately the same in the first fiscal quarters of both years.

- procedures to understand and evaluate the internal controls at the service organizations,
- substantive audit procedures on the activity in that portion of the portfolio between the period covered by the internal auditors' work and year end, except for high-level fluctuation analyses, and
- procedures to address the adverse findings in the internal auditors' report.

#### Issuer F

On the audit of this issuer, the Firm used a computer-assisted auditing procedure to identify potentially fraudulent journal entries. While the procedure identified certain entries, the Firm failed to examine them to determine whether any of them were fraudulent.

#### Issuer B

On this audit, the Firm failed to test the issuer's purchase price variance account, which is an integral component of the issuer's valuation of its inventory. In addition, the Firm's samples for other tests of the inventory account were smaller than necessary to obtain sufficient competent evidential matter because the Firm used the wrong method of sampling.

#### Issuer H

The Firm used analytical procedures to test the labor and overhead components of the issuer's inventory and to test the activity in the inventory accounts between the interim dates when the Firm observed the issuer's physical inventory counts and year end. These procedures, however, were not sufficient given the significant risk of material misstatement of the issuer's inventory and because they did not meet the requirements for substantive analytical procedures.

#### Issuer M

On one audit, the Firm's sample size for testing the additions to an asset account was insufficient because it did not meet the requirements for calculating sample sizes.

#### Issuer T

The Firm failed to evaluate the appropriateness of an issuer's classification of its net deferred income tax liability, representing approximately 12 percent of its total liabilities, as non-current.

#### Issuer AA

When auditing the completeness, existence and valuation assertions for deferred revenue, the sample of items tested by the Firm was inadequate because the Firm used the wrong method of sampling.

#### Issuer A

This issuer capitalizes certain installation costs upon acquiring new customers and amortizes them over the contract term. The Firm either failed to perform, or to include evidence in the work papers that it had performed, sufficient procedures when auditing these costs:

- While the Firm concluded that the issuer had applied its capitalization methodology in a consistent manner from year-to-year, there was no evidence that the Firm had tested the appropriateness of the methodology in the current or prior years.
- The Firm did not test whether the costs that were capitalized were capitalizable under GAAP.
- The Firm did not test the issuer's schedules of the current year's additions to capitalized installation costs, including the underlying data supporting the number of installations, which is a key component of the capitalization calculation.

#### Issuer BB

The Firm failed to test the claims data a third-party administrator provided to the issuer to enable the issuer to calculate its workers compensation and general, health, and dental insurance liabilities.

#### Issuer K

On this audit, the Firm used the issuer's internal auditors to assist in auditing cash at an interim date. The Firm, however, failed to perform, or failed to have the internal auditors perform, audit procedures on the activity in the cash accounts between the interim date and year end.

#### Issuer U

An issuer's net deferred income tax assets represented 14 percent of its total assets. The Firm assessed the potential effects of the exercise of stock options on the appropriateness of the net amount of the deferred income tax assets, but failed to assess its effect on the classification of those assets.

#### Issuer CC

The issuer had a note receivable from a shareholder that was secured by the shareholder's ownership interest in the issuer. The issuer considered the collection of the note to be uncertain and determined that the value of the note receivable should be based on the value of the shareholder's ownership interest in the issuer. The value of the shareholder's ownership was attributable in part to the anticipated settlement of the issuer's claim against a third party regarding the value of property that the issuer sold to the third party. In testing the amount asserted by the issuer to be realizable from the claim, and thus collectible under the note receivable, the Firm inquired of management regarding the basis for the issuer's estimate and its assessment of the likelihood of collection. The Firm, however, failed to obtain information to corroborate management's representations by, for example, making inquiries of the issuer's lawyers.

#### Issuer DD

The issuer executed a securitization arrangement under which it sold its investment in bonds to an investment broker who transferred the bonds into a qualified special purpose entity. In assessing whether this transfer qualified as a sale under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the Firm inappropriately relied on a legal opinion that was addressed to the investment broker and that described the transaction from the perspective of the investment broker.

## Issuer L

On this 2003 audit, the Firm failed to adequately evaluate the appropriateness of the issuer's accrued liability for certain medical costs. The issuer was created over a decade ago as the result of a spin-off. Under the terms of the spin-off agreement, the former owner of the issuer agreed to continue paying certain medical costs for certain employees, and these costs were subject to reimbursement by the issuer. The issuer maintained an accrued liability related to the reimbursable medical costs even though the Firm's work papers indicate that, in 1996, the previous owner had represented to the issuer's treasurer that the issuer did not owe any additional amounts and that the issuer would not be billed for any additional costs. In accepting the issuer's accrued liability for reimbursable medical costs at the end of 2003, the Firm relied on a letter from the issuer's legal counsel that had not been updated since July 2000.<sup>12/</sup>

### 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, and assignment of responsibilities; (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

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<sup>12/</sup> Following the inspection team's discussion with the Firm of this matter, the Firm performed additional audit procedures and identified a misstatement in the financial statements of the issuer related to this matter. The issuer subsequently restated its financial statements.

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 PwC with applicable requirements and standards related to auditing issuers. This process included reviews of components of selected issuer audit engagements completed by PwC. 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 PwC that could be expected to influence audit quality.

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

The inspection team reviewed aspects of selected audits performed by PwC. The inspection team chose the engagements according to the Board's criteria. PwC 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 certain selected engagements, the inspection team reviewed written communications between PwC 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. 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 issued a comment form on the matter and the Firm

provided a written response to the comment form. In certain instances, the inspection team requested the engagement team to consult with PwC's National Office personnel regarding the appropriateness of the Firm's response. In many cases, this consultation process resulted in resolution of the matter, either because the Firm agreed with the position the inspection team had taken and the Firm or the issuer took steps in light of the significance of the error to remedy the exception, or because the Firm was able to provide additional information that effectively addressed the inspection team's concerns.

## 2. Review of Seven Functional Areas

The inspection team conducted the procedures related to the review of the seven functional areas primarily at PwC's National Offices. With respect to six of the seven 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 PwC'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

The inspection team reviewed the Firm's policies and procedures related to partner evaluation; partner compensation; nomination and admission of new partners; and assignment of duties. 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 13 members of PwC'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 PwC 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.

b. Review of Independence Policies

The objectives of the inspection procedures in this area included evaluating PwC'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 PwC's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed PwC's internal inspection program as it relates to monitoring compliance with PwC's independence policies and procedures; examined the Firm's independence consultation process; and reviewed information concerning PwC'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 PwC's independence policies, practices and procedures.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, 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. Also for the sample, 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 PwC'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 PwC; 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 acceptance or continuance documentation was completed and approved in accordance with Firm policies; interviewed the audit partners and managers on these engagements concerning the reasons for accepting the issuer as a client or 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 the Firm's annual internal inspection program in enhancing audit quality, as well as to assess the Firm's compliance with PCAOB standards. To meet those objectives, the inspection team reviewed policies, procedures, guidance and forms at the Firm's National Office 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 the Firm'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 four practice offices where the Firm conducted internal inspections. These procedures included evaluating the qualifications of the Firm's inspectors, reading the inspectors' comments, and interviewing both regional and practice office leadership and selected audit personnel concerning the internal inspection program. In addition, for a sample of the engagements that the internal inspectors had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with the Firm 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 PwC'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 PwC 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. Except for one issuer where the inspection team requested access, which the Firm provided, 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 PwC'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. 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 the Firm'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 the Firm's National Office. Such information included the Firm's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, the Firm's staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; and agendas and minutes of the Firm's Board of Partners. In addition, the inspection team interviewed 13 members of the Firm's leadership team.

The inspection team conducted interviews at 18 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 certain of these offices, as well as certain audit partners and senior managers assigned to engagements that were reviewed. In addition, the inspection team conducted 20 focus group meetings in those 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. Ten of these focus groups meetings consisted of audit senior managers and audit managers, and ten were composed of audit senior accountants.

## **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.

October 26, 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: PricewaterhouseCoopers LLP Response to Draft Report on 2004 Inspection of PricewaterhouseCoopers LLP**

Dear Mr. Diacont:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") draft Report on 2004 Inspection of PricewaterhouseCoopers LLP (the "Report").

PricewaterhouseCoopers LLP's (the "Firm") top priority is to continuously improve audit quality and thereby to help restore investor confidence in the capital markets and the public accounting profession. We appreciate the constructive dialogue with the PCAOB Inspections Staff and their candor in articulating the points on which the Board believes improvement is needed. On balance, we believe we are executing quality audits; however, we take seriously the findings identified by the Board during the 2004 inspection of our 2003 audit engagements, and we will incorporate these findings into our ongoing audit quality improvement efforts. We have taken substantive steps to address the Board's concerns, and we believe the steps we have taken, and are continuing to take, will contribute to improved audit quality and are responsive to these findings.<sup>1</sup>

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<sup>1</sup> We have updated our policies, conducted training, improved technology, increased internal inspections, hired more resources, communicated our leadership expectations related to audit quality, and modified our partner evaluation and compensation process. These steps also include changes made to our audit methodology in response to the requirements of Sarbanes-Oxley Section 404 and PCAOB Auditing Standard No. 2 related to internal control over financial reporting, as well as PCAOB Auditing Standard No. 3 related to audit documentation, which became effective in 2004.

With respect to the findings identified by the Board in the 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*. For some findings, additional procedures were performed or enhanced documentation was prepared. For other findings, as described further below, we do not believe it was necessary to perform additional procedures.

We take seriously the Board's findings, and we recognize the need to more consistently execute and document our audit procedures in accordance with the PCAOB standards. We also recognize that the execution of an audit in accordance with the PCAOB standards requires the exercise of significant professional judgment, and that views may differ on matters such as the nature, timing and extent of audit procedures and the related documentation. We recognize the basis for the findings in Part I of the Report and agree with the conclusions related to certain of them. However, for many of the findings we respectfully disagree with the conclusions 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 that respect, for approximately two-thirds of the findings, we believe:

- The work performed was adequate in the context of the audit as a whole and therefore such findings represent good faith differences of opinion on the application of professional judgment.
- While certain individual tests may not have been completely sufficient, when the totality of the work done in the specific audit area was considered, and/or the significance of the test was evaluated in the context of the audit as a whole, the finding was considered not significant enough to warrant performing additional audit procedures.
- Appropriate testing was done, but the documentation in the work papers may not have completely captured all testing and/or the rationale underlying all conclusions. However, considering the totality of the procedures performed in the context of the audit as a whole, we believe that the documentation was adequate.<sup>2</sup>

Finally, we note that two of the restatements identified in the Report did not result from the Board's Inspection. Rather, these issues were appropriately identified and evaluated by the issuers and the Firm and resolved appropriately. One issue was appropriately concluded to be immaterial, and the other issue was appropriately concluded to be addressed prospectively in future financial statements via a reclassification within the balance sheet and statement of cash flows that had no impact on current or total assets, liabilities, equity, or net income.

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<sup>2</sup> We take seriously the need to document our audit procedures to comply with the Board's requirements under PCAOB Auditing Standard 3, *Audit Documentation*, which became effective in 2004. We have revised our audit documentation policies accordingly, and we continue to focus on the quality of our documentation through additional documentation policies and training.

\* \* \* \* \*

Section B. of Appendix B of the Report summarizes the Board's review of seven functional areas of the Firm, and Part II of the Report summarizes the Board's findings in these areas. As stated above, quality is our top priority and we are committed to continuously improving our audit quality. To that end, we will continue to incorporate the Board's observations into our efforts to improve the consistent execution of high quality audits. We look forward to communicating with the Inspections Staff and the Board our perspective on these findings and the substantive actions we have taken, and continue to take, in the areas addressed in the Board's Report.

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We appreciate the opportunity to express our views formally and would be pleased to discuss our response or answer any questions the Inspections Staff or the Board may have regarding our response.

Sincerely,

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*David A. Cooper*