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**Report on**  
**2005 Inspection of Deloitte & Touche LLP**

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

**November 30, 2006**

**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. 104-2006-202



### **Preface to Reports Concerning Annually Inspected Firms**

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("PCAOB" or "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 of financial statements and of internal control over financial reporting. 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 reporting on internal control, 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 the annually inspected 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.



During 2005, the Board monitored the implementation of the provisions of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2") by annually inspected U.S. firms. Among other things, that monitoring included Board staff meetings with these firms to discuss their methodology and to discuss opportunities to enhance the effectiveness and efficiency of audits of internal control. As the Board has previously stated, the Board believes that audits performed under the difficult circumstances of the first year of implementation of AS No. 2 were often not as efficient as the standard intends, and as the Board expects them to be in future years. The primary reasons for this failure to achieve expected efficiencies are described in the Board's Report on the Initial Implementation of Auditing Standard No. 2 ("the Report").<sup>1/</sup> In general, as described in the Report, in the 2005 inspections of certain firms, the Board's inspectors observed that, in a significant number of the engagements they selected for inspection of the application of AS No. 2, the auditors did not integrate their audits of internal control with their audits of the financial statements; did not use a top-down approach; and did not alter the nature, timing, and extent of their procedures to reflect the level of risk within a given area.

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<sup>1/</sup> See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (November 30, 2005).



### 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 U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure 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 or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



## 2005 INSPECTION OF DELOITTE & TOUCHE LLP

In 2005, the Board conducted an inspection of Deloitte & Touche LLP ("Deloitte" or "the Firm"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report, Appendix B, and portions of Appendix C. Appendix B provides an overview of the inspection process. Appendix C includes the Firm's comments, if any, on a draft of the report.<sup>2/</sup>

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.<sup>3/</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>2/</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 routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

<sup>3/</sup> See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

## **PART I**

### **INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS**

Members of the Board's inspection staff ("the inspection team") performed an inspection of the Firm from May 2005 to October 2005. The inspection team performed field work at the Firm's National Office and at 15 of its approximately 74 U.S. practice offices.

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 audits of financial statements and of internal control over financial reporting and the review of eight 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>4/</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 or reporting on internal control, 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 of financial statements and of internal control over financial reporting performed by the Firm. Those audits and aspects were selected according to the

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<sup>4/</sup> When the Board becomes aware 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's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

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. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the Firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claims to have performed the procedure. PCAOB Auditing Standard No. 3 ("AS No. 3"), in effect for most of the audits reviewed in the inspection,<sup>5/</sup> provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence.<sup>6/</sup> For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

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>7/</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

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<sup>5/</sup> Auditing Standard No. 3, *Audit Documentation*, applies to audits with respect to fiscal years ending on or after November 15, 2004.

<sup>6/</sup> See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

<sup>7/</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).



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>8/</sup>

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not 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 are described below (without identifying the issuers).<sup>9/</sup> The deficiencies are discussed here on an audit-by-audit basis, with one exception where two audits are grouped together because a certain type of deficiency was observed in both.

#### Issuer A

The issuer incorrectly recorded revenue from two of its four revenue-producing agreements net of certain reimbursed costs. In accordance with Emerging Issues Task Force ("EITF") No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, the revenue under these agreements should have been presented on a gross basis. The Firm should have identified and addressed this error before issuing its audit report.<sup>10/</sup>

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<sup>8/</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.

<sup>9/</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>10/</sup> The issuer has restated its financial statements related to the matter discussed here.



## Issuer B

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

- The issuer entered into multiple-element software sales contracts that generally included a license fee and a maintenance element. The maintenance element was priced as a percentage of the license fee. Documentation of the issuer's revenue recognition policies was limited to an issuer-prepared memorandum dated in 2002. Since that time, the issuer has acquired three additional entities; however, the Firm failed to consider the appropriateness of the issuer's methods of recognizing revenues with respect to each acquired entity's unique software license and maintenance contracts, which provide for varying levels of maintenance and varying maintenance renewals as a percentage of the license fees. In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed whether a change in a maintenance renewal rate on its standard price list affected the timing of the issuer's recognition of revenue.
- More than half of the issuer's revenue was realized through partnering relationships with indirect channel partners and independent software vendors that develop and market applications using the issuer's technology. The issuer has extensive information available about its partnering programs. For example, it has substantial information in its Form 10-K and on its website. The descriptions appear to indicate that the issuer is providing its partners with assistance in several areas, including marketing and developing enhanced application solutions. The Firm, however, failed to consider the specific terms of the issuer's various partnering relationships and whether they fell within the provisions of EITF No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)* ("EITF No. 01-9"), which may affect the issuer's recognition of revenue from its partnering relationships. In spite of the apparent indicators of potential consideration given to the partners, the Firm's work papers failed to evidence how the Firm concluded that the issuer's accounting was appropriate, as the work papers simply included a check mark on a checklist indicating that EITF No. 01-9 did not apply.

## Issuer C

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

- During the third quarter of 2004, the issuer identified and corrected a prior period tax error, and during the fourth quarter of 2004, it identified and corrected three additional prior period tax errors. In evaluating the impact of these errors on the current and prior periods, the issuer improperly netted them against other amounts considered to be appropriate current period tax adjustments. The Firm failed to properly consider the impact of the individual errors on the current and prior periods.
- The work papers contained unsupported and unreconciled amounts in numerous accounts, including accounts receivable, prepaid expenses, miscellaneous prepaids, other current assets, accounts payable, other deferred credits, and foreign currency translation. The Firm also identified known errors that it dismissed as not warranting further investigation or discussion or adjustment to the financial statements. Certain of the items were posted to the summary of passed adjustments, others were posted to a schedule of passed disclosure items, and others were left in the work papers without a final disposition even though they exceeded the Firm's de minimis posting threshold.

The Firm documented on its summary of passed adjustments (*i.e.*, its Evaluation of Misstatements work paper) that the passed adjustments included items that –

- appeared to be intentional;
- were clear departures from GAAP that management had agreed were departures from GAAP;
- were capable of precise measurement;
- could be corrected with little cost or effort; or
- management had avoided taking action on to correct on a timely basis.

During the inspection, the Firm indicated that it understood that the issuer closely monitored its earnings estimates against its target earnings per share ("EPS") and potential changes in its EPS. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed the potential effect of the misstatements that it had identified on whether the issuer met its target EPS. Also, the Firm documented on its Evaluation of Misstatements work paper that, had the unrecorded misstatements been recorded, the issuer's management's compensation would have decreased. The Firm's analysis of the misstatements did not include entries posted to the summary of disclosure items passed and those not carried forward to either summary.

#### Issuer D

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

- The issuer amortized certain current assets over a one- or two-year period depending on whether the asset was to be used for an existing or a new customer, respectively. The issuer estimated that the useful life of these assets was between 12 and 14 months. The Firm failed to determine the amount of the error resulting from amortizing certain of these assets over a period that was in excess of their useful lives.
- The issuer acquired customer contracts in the current year and estimated the useful lives of these contracts to be 15 years. In previous years, the issuer had estimated that the useful lives of similar contracts ranged from three to ten years. Other than the oral representations that the Firm obtained from the issuer, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained and evaluated historical evidence related to the useful lives of the contracts that led to the change in estimate to 15 years, and had evaluated the impact of this change on the estimated useful lives of its previously acquired customer contracts.

#### Issuer E

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

- The issuer completed an acquisition of a business during the year and recorded the acquired property, plant, and equipment, and an asset retirement obligation, in its financial statements. The audit documentation did not evidence sufficient testing of the purchase accounting, including testing of fair values allocated to certain assets and liabilities, useful lives assigned to the acquired assets, and the amount of the asset retirement obligation. In addition, there was no evidence that the Firm (1) evaluated the qualifications and relationships to the issuer of the specialists used to determine the fair values of certain of the acquired assets and liabilities, (2) obtained an understanding of the methods and assumptions used by the specialists, or (3) tested the data used by the specialists.
- The work papers also did not evidence whether the Firm considered the recoverability of a long-lived asset despite the presence of impairment indicators.

#### Issuer F

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

- The Firm used positive confirmations in auditing the issuer's accounts receivable. The confirmations contained language that incorrectly requested the customer to confirm amounts that the issuer owed it instead of amounts it owed the issuer. Rather than sending revised, corrected confirmations after discovering this error, the Firm relied on affirmative responses that came back without the confirming party having noted the error, and the Firm made notations on those responses to indicate that the amount was owed to the issuer, rather than the other way around. In addition, after mailing the confirmations, the Firm identified an error in the data it had used to determine the sample size, and determined that it could use a smaller sample size. As a result of decreasing the sample size, the Firm disregarded a number of the returned confirmations, regardless of the response. For the majority of the remaining confirmations, the Firm either made the notations described above or did not perform sufficient alternative procedures on those that were not returned, in that the Firm failed to test those amounts that had not been paid.

- The Firm's sample size for testing vendor rebate income and related receivables was not sufficient because it was not determined in a manner that would provide the Firm with reasonable assurance that it would detect misstatements in those accounts that, in the aggregate, could constitute a material misstatement of the financial statements. In addition, for a significant portion of the sample, there was no evidence in the work papers to indicate that the Firm compared the cash received to the vendor rebate agreements to determine whether the cash receipts were appropriately accounted for as income during the current period.

#### Issuer G

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

- The issuer acquired computer software products through several acquisitions during the year and valued them using a cost method based on estimates of the acquired entities' costs to develop the software. This approach resulted in approximately seven percent and 79 percent of the purchase prices being allocated to acquired software products and goodwill, respectively. Statement of Financial Accounting Standards ("SFAS") No. 141, *Business Combinations*, requires acquired computer software to be recorded at estimated fair values, not at an estimate of the acquiree's development costs. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the issuer's use of the acquiree's development costs resulted in the issuer recording the acquired software products at their estimated fair values.
- The issuer also entered into software revenue contracts that included multiple elements. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested how the issuer had allocated value to each element of the contracts, based on vendor-specific objective evidence ("VSOE"), and therefore the Firm did not assess whether the appropriate amount of revenue was recognized in the proper period.

#### Issuer H

During its testing of inventory valuation in this audit, the Firm identified certain errors. The Firm, however, did not ascertain whether the population it tested was complete, and the sample size for the test was too small to enable the Firm to make a meaningful estimate of the total error in the population.

#### Issuer I

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

- The Firm's work papers for the third quarter included an issuer-prepared memorandum supporting the issuer's tax reserves. In the fourth quarter, the issuer eliminated the reserves. There was no evidence that the Firm performed any audit procedures on the elimination of the reserves beyond obtaining a management-prepared document that did not provide a persuasive rationale for the elimination.
- In connection with auditing inventory valuation, the Firm tested controls and performed substantive tests. The controls that the Firm identified and tested, however, did not address whether the inventory was properly valued or whether the variances were accounted for appropriately, and the substantive tests did not address whether inventory was properly valued at year end.

#### Issuer J

The issuer accounted for revenue associated with a multiple-element arrangement that included leased assets by allocating the consideration received to the lease component based on its fair value and allocating the remaining consideration to the non-lease component without any consideration of its fair value. The engagement team consulted with the Firm's National Office, which concluded that, in accordance with GAAP, the consideration should be allocated based on the relative fair values of the components. Nonetheless, the engagement team accepted the issuer's accounting for this arrangement without evaluating the effect of this departure.

#### Issuer K

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

- The issuer recognized revenue from the rental of equipment upon the occurrence of certain events, which usually happen within a few days of delivery of the equipment, rather than over the term of use. The Firm did not evaluate whether revenue should have been recognized over the term of use.
- There was no evidence in the audit documentation, and no persuasive other evidence, that, when evaluating the issuer's allocation of the costs of assets acquired in a series of business combinations, the Firm had evaluated whether all separately identifiable intangible assets had been recognized and valued, and whether the Firm had considered the acquired businesses' deferred revenue.

#### Issuers L and M

In each of these audits, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient tests of the issuer's allowance for loan losses ("ALL"). Most significantly, in reviewing and testing management's process for developing these issuers' estimates, the Firm failed to test the significant qualitative adjustments that management had applied to the historical loss percentages used in the calculations.

#### Issuer N

There was no evidence in the audit documentation, and no persuasive other evidence, that, other than tracing the amounts to an issuer-prepared schedule, the Firm had tested the issuer's statement of cash flows, such as by comparing the amounts to support in the Firm's work papers.

#### Issuer O

The issuer has public debt subject to covenants that require it to maintain certain financial ratios and refrain from certain transactions without prior approval of the debt holders. There was no evidence in the audit documentation, and no persuasive other



evidence, that the Firm had tested whether the issuer complied with these debt covenants.

#### Issuer P

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

- When testing inventory, the Firm applied a controls reliance strategy, which included reliance on IT controls. The Firm's work papers indicated that the results of its tests of the issuer's information technology general controls did not support a conclusion that the issuer's information processing was reliable. The Firm, however, did not perform any additional procedures to address its finding, nor did it modify its audit strategy.
- Other than reviewing certain untested reports for reasonableness, there was no evidence that the Firm performed audit procedures, such as examination, observation, or re-performance, to obtain corroboration of management's explanations regarding a significant portion of the inventory controls identified for testing.

#### Issuer Q

There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm, in evaluating the issuer's allocation of the costs of assets acquired in a series of business combinations, had tested management's assertion that the acquired inventory was recorded at an estimate of the selling price, less the cost of disposal and a reasonable profit allowance for the selling effort. Also, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether all separately identifiable intangible assets had been recognized and valued.

#### 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 eight functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of

non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. issuer 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 the Firm with applicable requirements and standards related to auditing issuers. This process included reviews of components of selected issuer audit engagements completed by the Firm. These reviews were intended both to identify deficiencies, if any, in the conduct of those audits and to determine whether the results of those audits indicated deficiencies in the design or operation of the Firm's system of quality control over audits. In addition, the inspection included reviews of the design of, and in some cases the application of, policies and procedures related to certain functional areas of the Firm that could be expected to influence audit quality.

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

The inspection team reviewed aspects of selected audits performed by the Firm. The inspection team chose the engagements according to the Board's criteria. The Firm 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, consideration of fraud, 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 the Firm and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

The inspection team also reviewed aspects of certain of the Firm's audits of internal control over financial reporting. For each audit engagement selected for this purpose, the inspection team reviewed the Firm's work papers and interviewed engagement personnel regarding the audit approach, including the use of a top-down

approach, the assessment of risk, the evaluation of management's assessment of internal control, and the integration of the audit of internal control over financial reporting with the audit of the financial statements. The inspection team also selected certain significant processes and, for those processes, reviewed the Firm's evaluation of the design effectiveness of controls, including the performance of walkthroughs, and the performance of tests of operating effectiveness of controls. For the selected engagements, the inspection team also reviewed the Firm's evaluation of any control deficiencies that the Firm identified during the Firm's audit of the issuer's financial statements.

When the inspection team identified a potential issue, it discussed the issue with members of the 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, if the inspection team was unable to resolve the issue through these processes, the inspection team requested that the engagement team consult with Deloitte's professional practice personnel, who include local office professional practice directors ("PPDs"), regional professional practice directors ("RPPDs"), and members of the National Office professional practice group. In many cases, this 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 Eight Functional Areas

The inspection team conducted the procedures related to the review of the eight functional areas primarily at the Firm's National Office. With respect to seven of the eight functional areas, the inspection team also conducted procedures at certain of the Firm's practice offices. The inspection team performed these procedures both to identify possible defects in the Firm's system of quality control and, where applicable, to update the Board's knowledge of the Firm's policies and procedures in the functional areas. A more detailed description of the scope with respect to each of the eight functional areas follows.

a. Review of Partner Evaluation, Compensation, Admission, 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, assignment of responsibilities, disciplinary actions, and termination of partners. The objective of the inspection procedures was to assess 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 nine members of the Firm's leadership at its National Office, as well as members of leadership and audit partners in practice offices, regarding these topics. In addition, the inspection team analyzed schedules provided by the Firm that detailed information on each partner, including the partner's office 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 the Firm's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer audit clients; Firm participation in business ventures, alliances, and arrangements; commissions and contingent fee arrangements; personal financial interests and the relationships of Firm professionals with issuer audit clients; and the provision of non-audit services related to issuer audit clients' compliance with Section 404 of the Act. To accomplish these objectives, the inspection team reviewed the Firm's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed the Firm's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures; tested the Firm's independence consultation process; and reviewed information concerning the Firm'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 the Firm'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 commissions or contingent fee arrangements; to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement; and to determine whether the Firm was involved in any business ventures, alliances, or arrangements with the issuer. In addition, for the sample, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

c. Review of Client Acceptance and Retention Policies

The 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 the Firm'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 the Firm; 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, contemplated in response to any identified risks.

d. Review of Practices for Consultations

The objective of the inspection procedures in this area was to assess the Firm's compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters. Toward this objective, the inspection team gained an understanding of and evaluated the Firm's policies and procedures relating to its consultation process. The inspection team also reviewed a sample of consultations that



occurred during the inspection period to evaluate the effectiveness of the Firm's consultation process, the Firm's compliance with its policies and procedures, whether the conclusions were in accordance with professional standards, and whether the engagement teams acted in accordance with the conclusions.

e. 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 the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance, and forms related to the Firm's internal inspection program, documentation of the results of the current year's inspection program, and steps the Firm took 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 two practice offices where the Firm had 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 the Firm any significant differences in the results of the inspection team's review and that of the Firm's internal inspectors.

f. 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 policies that the Firm had made since the Board's most recent inspection of the Firm.

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 with respect to selected specific areas. The inspection team also evaluated the effectiveness of the design of the Firm's processes for monitoring developments that could affect the Firm's audit policies, procedures, and methodologies.

g. Review of Policies Related to Foreign Affiliates

The objective of the inspection procedures in this area was to evaluate the processes the Firm uses to ensure that the audit work that its foreign affiliates perform 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 the Firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the foreign operations of U.S. issuer clients; analyzed audit guidance related to planning and administering multi-location engagements; and reviewed available information relating to the most recent foreign affiliated firms' internal inspections. In addition, the inspection team interviewed members of 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 the engagements reviewed, the inspection team reviewed the U.S. engagement team's supervision and control procedures concerning the audit work that the Firm's foreign affiliates performed.

h. Review of Tone at the Top

The 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 directors. In addition, the inspection team interviewed numerous members of the Firm's leadership team.

The inspection team conducted interviews at 12 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.

## **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 Firm provided a written response to a draft of this 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.<sup>11/</sup>

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<sup>11/</sup> 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. In some cases, the result may be that none of the Firm's response is made publicly available.



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October 25, 2006

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

Re: Deloitte & Touche LLP – Response to Part I of Draft Report on 2005 Inspection

Dear Mr. Diacont:

Deloitte & Touche LLP (“D&T”) is pleased to submit its response to the Public Company Accounting Oversight Board’s (the “Board”) September 22, 2006 draft of its Report on 2005 Inspection of Deloitte & Touche LLP (the “Draft Report”). We are supportive of the inspection process and believe the Board’s comments and observations enhance the ability to achieve our shared objective of improving audit quality.

D&T is committed to the highest standards of audit quality. We continually monitor the systems and processes for our audit practice, including quality control, and, among other things, make changes to methodologies, policies, and procedures when we identify improvements that could enhance audit quality. As we have done with respect to the Board’s previous inspection reports, we will thoroughly consider the Board’s comments and concerns addressed in the Draft Report (including any revisions that might be made before the report is formally issued), assess whether we have already initiated actions that address those concerns, and consider whether additional actions are necessary.

We have evaluated the matters identified by the Board’s inspection team for each of the seventeen Issuer audits described in Part I of the Draft Report and have taken appropriate actions. In evaluating the matters identified, we have considered whether it was necessary to perform additional auditing procedures in accordance with AU 390, *Consideration of Omitted Procedures After the Report Date*, and in five instances we performed and documented additional auditing procedures, which did not change our conclusions or affect our reports on the Issuers’ financial statements. With respect to the single material departure from generally accepted accounting principles cited in the Draft Report, the Issuer client and we considered AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, and, as noted in the Draft Report, this Issuer has restated its financial statements to correct this accounting error.

Part I of the Draft Report states, in comments regarding several audits of Issuers, “...the Firm failed in [number] respects to obtain sufficient competent evidential matter to support its opinion...” We disagree with these assertions with respect to the eleven Issuer audits discussed below. The Board’s standards provide that the nature and extent of documentation are determined using the auditor’s judgment. Although in certain instances the documentation for the matters cited in the Draft Report might not have been as extensive as, or organized in a manner that, the reviewers would have preferred, we believe that the documentation is in compliance with the Board’s standards and supports the conclusions reached. Moreover, we believe many of the assertions of an insufficiency of competent evidential matter are not supported with any specificity regarding what evidential matter was omitted.

Member of  
**Deloitte Touche Tohmatsu**

With respect to comments on seven Issuer audits described in Part I of the Draft Report that relate to the inspection team's concerns regarding the adequacy of documentation, where we believed additional clarification might be helpful, currently dated documentation has been added to the working papers to more clearly describe the procedures performed, evidence obtained, and conclusions reached, although we believe that the original documentation was sufficient to comply with the Board's standards and supports the conclusions reached.

We have the following specific disagreements with respect to the comments on the remaining four of the Issuer audits described in Part I of the Draft Report:

- Issuer B. We disagree with these comments. Each of the three matters cited was addressed by the engagement team during the audit, and the procedures performed, evidence obtained, and conclusions reached are documented in the working papers. Our detailed responses to the inspection team's comments, in which we strongly disagreed with the inspection team's comments and conclusions, cited numerous specific working papers where the questions raised by the reviewers were appropriately addressed.
- Issuer C. We disagree with these comments, which are presented in a manner that could result in a reader of the report reaching inaccurate and inappropriate conclusions. For example, in the first bullet, the Draft Report asserts, "the issuer netted [prior period tax errors] against other amounts considered to be appropriate current period tax adjustments." This assertion by the inspection team is not supported by the facts. The Issuer and the engagement team clearly concluded that the referenced "other amounts" were not current period tax adjustments, but were prior period errors that individually and in the aggregate were not material to the current or prior periods. Also, with respect to the matters cited in the second bullet, although certain of the errors identified were not posted to the summary of passed adjustments as required by D&T policy, the nature of the errors and the conclusions regarding the effect on the financial statements were documented in the working papers individually and were appropriately considered by the engagement team in reaching the overall conclusions with respect to the adequacy of the scope of the audit and the impact on the Issuer's financial statements. Subsequent to the inspection, the engagement team prepared and presented to the Issuer's audit committee a revised summary of passed adjustments to more clearly document that the errors were not material in the aggregate. This revision did not require a change to the engagement team's overall conclusions or affect our report on the Issuer's financial statements. It should be noted that several of the matters included in the second bullet (e.g., the entire second paragraph and the first and third sentences of the third paragraph) were not included in the written comments presented to us by the Board's inspection team. Nevertheless, the engagement team at the time of the audit, appropriately considered all relevant qualitative and quantitative factors in reaching its conclusions, as documented in the working papers.
- Issuer M. We disagree with this comment. Our detailed responses to the inspection team's comments cited numerous specific working papers where the questions raised by the reviewers were appropriately addressed.
- Issuer N. We disagree with this comment. The comment in the Draft Report contradicts the inspection team's own written comment on this matter, which reads, in part, "...The engagement team was able to provide supporting documentation to enable the inspection team to conclude that the amounts included in the statement of cash flows were supported in the working papers, except for the following line items..." indicating that except for the two line items cited the work had been performed and was evidenced in the working papers.

October 25, 2006

Page 3

In developing our detailed response to the Draft Report, we carefully considered the extent to which we believed it is prudent to disagree with the comments in the Draft Report. As stated previously, we support the Board's inspection process. At the same time, we are concerned that comments on matters that rely on the exercise of professional judgment should be approached with particular care by the Board, given the subjective nature of such issues. Further, we believe that the efficacy of the inspection process itself is compromised if public reporting of inspection comments on individual audits by registered public accounting firms is based on information not previously shared with the inspected firm. We respectfully request that the Board reconsider issuing the comments detailed above in its final report on the 2005 inspection.

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We are available to the Board and its staff to discuss our response in further detail. Please contact James V. Schnurr at 203.761.3539, Guy W. Moore at 203.761.3226, or Tracey C. Golden at 203.761.3468 with any questions.

Sincerely,

*Deloitte + Touche LLP*