



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

**Report on**  
**2005 Inspection of Grant Thornton 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. 104-2006-203

**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 inspecting 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 GRANT THORNTON LLP

In 2005, the Board conducted an inspection of Grant Thornton LLP ("Grant" 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 January 2006. The inspection team performed field work at the Firm's National Office and at 13 of its approximately 49 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

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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.

performed by the Firm. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies. Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements. The deficiencies also included a failure by the Firm to identify or appropriately address a material weakness in internal control. 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>

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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).

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>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 or had not obtained sufficient competent evidential matter to support its opinion on internal control over financial reporting. 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.

#### Issuer A

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

- The issuer classified outstanding restricted share units as a liability rather than as a component of stockholders' equity. This amount represented approximately 23 percent of the issuer's total liabilities. 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 this matter.

- During the year, the issuer adopted a new method of depreciation for all newly acquired fixed assets. The issuer, however, did not quantify the effect of the change and did not disclose the change. The Firm failed to evaluate whether the issuer's approach to the change was consistent with Accounting Principles Board Opinion ("APBO") No. 20, *Accounting Changes*.<sup>11/</sup>
- The issuer was the managing general partner for various affiliated investment partnerships, one of which was consolidated by the issuer. The total assets of the unconsolidated affiliated investment partnerships approximated 516 percent of the issuer's total assets. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether, under Statement of Financial Accounting Standards ("SFAS") No. 94, *Consolidation of All Majority-Owned Subsidiaries*, these partnerships should have been consolidated.
- Approximately 67 percent of the issuer's fee revenue was derived from clients that were affiliated with the issuer. The Firm determined that this circumstance required additional audit procedures due to the potential for fraud. While the Firm tested the receipt of fee revenue from these affiliated clients, it did not test whether these revenues were recognized in accordance with the terms of the underlying contracts and GAAP, which the Firm had planned to do to mitigate the fraud risk it had identified.
- The Firm failed to perform sufficient audit procedures with respect to the issuer's incentive compensation expense, which approximated 50 percent of the issuer's total expenses. For 71 percent of the total incentive compensation expense, the Firm did not verify that the incentive compensation was appropriately authorized. In addition, while the Firm performed a reconciliation of the issuer's incentive compensation expense and related liability to payroll reports produced by an outside service organization, the Firm did not address significant unreconciled amounts. Further, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested controls over the

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<sup>11/</sup> The issuer has restated its financial statements related to this matter.

preparation of the payroll reports on which it relied, other than testing access to the payroll system.

#### Issuer B

In the audit of internal control over financial reporting, the Firm failed to identify a material weakness in the controls over the issuer's allowance for sales returns (ASR) process. The ASR was derived through an estimation process based on management's assumptions and historical data. There was, however, no evidence in the audit documentation, and no persuasive other evidence, that the Firm had identified controls to address points at which material misstatements could occur in the ASR process, or had tested the design and operating effectiveness of those controls, including controls related to information that was provided by a service organization and used to estimate the ASR.<sup>12/</sup>

The Firm also failed to obtain sufficient competent evidential matter to support its opinion on this issuer's financial statements. The Firm failed to perform sufficient audit procedures on the underlying data and the assumptions used in calculating the ASR. For example, although the Firm compared certain information to a report, received from the service organization, on which it relied, the Firm did not test this report for completeness and accuracy.<sup>13/</sup>

#### Issuer C

In this audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The issuer classified its revolving line of credit, which included both a subjective acceleration clause and a provision for a lock-box arrangement, as a long-term liability rather than as a current

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<sup>12/</sup> The Firm has revised its report on management's assessment of the effectiveness of internal control over financial reporting and on the effectiveness of internal control over financial reporting to indicate that the control deficiency related to the allowance for sales returns was a material weakness.

<sup>13/</sup> The issuer has restated its financial statements for the years ended December 31, 2002, 2003, and 2004 and for the first quarter of 2005 to make changes in its accounting for sales returns and other matters.

liability. The issuer's classification was not in accordance with Emerging Issues Task Force No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.

#### Issuer D

In this audit, the Firm failed to sufficiently evaluate the appropriateness of the issuer not recording a liability related to certain customer contracts. The issuer changed its accounting for the revenue from the contracts. After the accounting change, the issuer continued to record a liability for known claims but ceased recording a liability for certain incurred but not reported claims related to the contracts. Information was available to the Firm that suggested that the unrecorded liability could be material.

#### Issuer E

In this audit, the Firm failed in the following respects to adequately test rental income, which represented 94 percent of the issuer's total revenue –

- The Firm failed to evaluate the appropriateness of the issuer's exclusion of required future lease rental payments for leases with expirations beyond ten years, as well as the exclusion of required future lease rental payments for all leases to businesses in certain industries, from its computation of the rents to be recognized on a straight-line basis over the terms of the leases.
- The Firm tested minimum rental income primarily through the use of analytical procedures that did not meet the requirements for substantive analytical procedures, as the Firm did not set an expectation that was precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated, would be identified for investigation.
- The Firm did not resolve the differences it noted in the sample of items it tested related to the straight-line rent adjustment, nor did it extrapolate the differences to the issuer's entire population of leases.

## Issuer F

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

- During the year, the issuer discovered that certain loans had been obtained from it through fraudulent means. The issuer filed a claim with its insurance company, and it reclassified the portion of the loans that was not collateralized to other assets as a receivable from the insurance company. The insurance company denied the claim and provided a detailed explanation of the reasons. The issuer's outside counsel for this matter prepared a memorandum for the issuer that concluded that it is probable that the issuer will succeed on its claim against the insurance company; however, the memorandum did not address each of the insurance company's reasons. The Firm failed to obtain written representations from the issuer's inside and outside counsels that supported recognizing the claim as an asset. In addition, the Firm failed to clarify whether certain terms in the outside counsel's memorandum were intended to have the same specific technical meaning as in SFAS No. 5, *Accounting for Contingencies*.
- The Firm failed to perform sufficient audit procedures related to certain customer deposits, which were approximately 34 percent of the issuer's total liabilities. The Firm's tests of controls were not sufficient to support a reduction in the Firm's substantive procedures, as they were not performed throughout the year under audit and did not include tests of controls over certain major classes of transactions, such as wire transfers, check processing, and automated clearing house transactions. In addition, while the Firm identified material weaknesses in the issuer's internal controls over customer deposits, including inappropriate access to the deposit system, the Firm did not modify the nature, timing, and extent of its substantive audit procedures. The Firm received a service auditor's report for the deposit system; however, the Firm identified deficiencies in the related user controls including the material weakness discussed above, which were not otherwise mitigated. The Firm's other audit procedures in this area included scanning, inquiry, high-level analytical procedures that did not meet the requirements for substantive analytical procedures, and negative confirmations even though the conditions for using negative confirmations were not met. In light of the material weaknesses and the fact that the combined assessed level of

inherent and control risk was not low, the Firm failed to perform sufficient audit procedures in these areas.

#### Issuer G

In this audit, the Firm did not perform sufficient audit procedures to test the allowance for loan losses. The Firm's procedures for certain loans were limited to recalculating and comparing reserve factors from the current year to prior years and obtaining explanations from the issuer for changes. With respect to other loans, the Firm's procedures were limited to recalculating the factors.

#### Issuer H

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

- Goodwill represented approximately 30 percent of the issuer's total assets. The issuer has a history of significant losses and an accumulated deficit. The Firm's procedures related to the evaluation of the issuer's projections, which the issuer used to evaluate whether goodwill was impaired, were limited to the first year of the projections, even though the issuer's goodwill would not be recovered at the end of that first year. As a result, the Firm did not have a reasonable basis to conclude that the issuer's goodwill was not impaired.
- The issuer completed ten acquisitions during the year. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient procedures related to these acquisitions. While the work papers included a schedule of acquisitions during the year, the audit procedures documented were limited to recalculating the mathematical accuracy of the purchase price. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had reviewed the purchase agreements or tested the purchase price allocation. In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested the completeness of the contingent consideration accrual, evaluated whether the accrued amounts were in accordance with the earn-out agreements, or tested payments during the year, including evaluating whether any of the amounts paid represented additional goodwill or compensation expense. Also, there was no evidence in

the audit documentation, and no persuasive other evidence, that the Firm had tested the amounts in the footnote disclosure related to the contingent earn-outs.

#### Issuer I

Management estimates were a significant component in determining the issuer's revenues and expenses and the period over which they were recognized or deferred. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient procedures to audit these management estimates. The substantive procedures regarding certain estimates were limited to inquiry and observation. For other estimates, the Firm performed only analytical procedures that did not meet the requirements for substantive tests because the Firm did not develop an expectation or a threshold for further investigation.

#### Issuer J

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

- The issuer accounted for its loan portfolio, which represented 91 percent of its total assets, at the lower of cost or market. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed appropriate procedures to test the loans' market values. The Firm's documented testing was limited to obtaining pricing data from the issuer. In addition, although the Firm assessed the control risk and inherent risk relating to loan valuation as high and moderate, respectively, the Firm did not consider these levels of risk when determining the sample size for testing whether the loans were valued at the lower of cost or market, and consequently the Firm's sample size was insufficient.
- The Firm failed to perform sufficient audit procedures with respect to the issuer's gain on sales of loans, which approximated 83 percent of the issuer's total revenue. The absence of evidence in the audit documentation, and of any persuasive other evidence, indicates the following –
  - The Firm failed to determine whether certain sales of loans that it tested qualified for sales accounting under SFAS No. 140, *Accounting for*

*Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

- The Firm failed to test the underlying data used in the issuer's gain-on-sale calculation for certain loans it tested, other than vouching the proceeds received on certain sales of loans to the receipt of cash and comparing information on one issuer-prepared document to other issuer-prepared documents.
- The Firm failed to test adequately the underlying assumptions used by the issuer to value residual interests on two significant transactions. While the Firm performed comparisons of the issuer's assumptions to peer data, and comparisons of the issuer's projections to actual data for certain periods, it failed to address significant differences resulting from these comparisons, as well as to test certain inputs to the issuer's valuation model.
- The Firm failed to test the underlying data and assumptions that the issuer used to calculate its recourse liability related to sales of loans, other than comparing the current year's charge-off data used in the issuer's calculation to the general ledger.

Issuer K

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

- Loans receivable represented 83 percent of the issuer's total assets. The Firm sent negative confirmations to test loans that were originated in the current year. While the Firm vouched the details of a sample of loans to source documents in the issuer's loan files, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed tests of controls, including tests of operating effectiveness of information technology controls, that would be sufficient to support a combined inherent and control risk assessment of low, without which the use of negative confirmations is inappropriate.
- Loans originated in prior years constituted approximately 60 percent of the issuer's total loans receivable. The Firm tested these loans by vouching

approximately 0.03 percent of the loan repayments in the current year to the receipt of cash. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed any other audit procedures to test the current balance of these loans.

- The issuer's methodology for calculating the allowance for loan losses used its historical default and recovery rates. The Firm's documented audit approach regarding the allowance for loan losses was to review and test management's process for developing this estimate. The Firm, however, did not adequately test the data and assumptions used to derive the default and recovery rates. While the Firm compared certain default rates to internal reports prepared by the issuer, the Firm did not test these reports. In addition, the Firm did not test the issuer's process for deriving many other default and recovery rates used in the calculation, did not test the historical data that the issuer used, and did not evaluate the issuer's justification for the selection of such data.

#### Issuer L

The issuer maintains a valuation allowance against certain of its deferred income tax assets. The Firm did not evaluate the recoverability of the individual components of the deferred tax assets, but rather evaluated recoverability "in total." This evaluation did not provide a basis to conclude whether the valuation allowance was appropriate. In addition, during the year, the issuer reduced its income tax contingency reserves. The Firm did not have a basis to conclude on the appropriateness of either the issuer's recorded income tax contingency reserves or the reduction in the reserves.

#### 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, 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 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 the Firm's National Office. 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 six members of the Firm's leadership at its National Office, as well as members of leadership 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, and to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement. 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 three 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; 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 interviewed members of the leadership at seven 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.

## **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>14/</sup>

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<sup>14/</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.

Accountants and Business Advisors

November 10, 2006

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

**Re: Grant Thornton LLP Response to Part I of 2005 PCAOB Draft Report of Inspection**

Dear Mr. Diacont:

Grant Thornton LLP's top priority is to continuously improve our audit and quality control processes to ensure we conduct high-quality audits. We appreciate the viewpoint and dialogue with the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Inspections Staff and are pleased to submit our response to Part I of the PCAOB draft Report on the 2005 inspection of Grant Thornton LLP dated October 11, 2006.

The Board's draft inspection report includes comments on individual audits which, either explicitly or implicitly, indicate that the Inspections Staff believed that there were departures from generally accepted accounting principles or that our auditing procedures were not sufficient. The issues raised by the Inspections Staff reflect the complexity of accounting and auditing standards and the critical need to apply professional judgment in performing auditing procedures and reaching conclusions. In many situations, the professional judgments of reasonable and highly competent people about appropriate accounting treatments or sufficiency of auditing procedures will differ. We have made every effort to cooperate fully, understand the Inspections Staff's views and carefully consider their judgments.

We do not agree, however, with the use of overly broad comments such as "failed to identify," "failed to perform" or "failed to evaluate." Such comments do not adequately describe the procedures performed since they imply that no procedures were performed and/or an issue was not addressed. For example, such is the case with respect to the accounting matter noted for Issuer C. For this engagement, the Board stated that "...the Firm failed to identify a departure from GAAP..." We respectfully disagree since the engagement team identified the matter and performed a thorough evaluation of the facts and an assessment of the issuer's conclusions. The engagement team then timely consulted with the Firm's National Professional Standards Group in accordance with Firm policy. We believe the conclusions reached are appropriate and the financial statements are presented in accordance with generally accepted accounting principles.

Another example is the comment relating to Issuer D. The Board stated "...the Firm failed to evaluate the appropriateness of the issuer not recording a liability related to certain customer contracts..." We respectfully disagree since the issue was appropriately identified, a liability was recorded and, in our judgment, we reached an appropriate conclusion.

For each matter described in Part I, we considered our responsibilities under AU 390, *Consideration of Omitted Procedures after the Report Date* and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditors' Report*.

175 W. Jackson Blvd.  
20th Floor  
Chicago, IL 60604  
T 312.856.0200  
F 312.565.4719  
W [www.grantthornton.com](http://www.grantthornton.com)

Grant Thornton LLP  
US Member of Grant Thornton International

In each matter, we considered the Board's comments and took action as we deemed appropriate. These actions included performing additional procedures and/or adding documentation.

We support the Board's inspection process and believe it will improve audit quality. The process could be substantially improved if we were provided an opportunity to discuss the Board's preliminary conclusions prior to the issuance of the final draft report. This would facilitate sharing of information and allow us to implement quality improvements on a more timely basis.

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We believe that as a result of the inspection of numerous accounting firms, the Board has obtained significant knowledge and understanding of each of the firms' audit methodologies, risk assessments, policies and procedures. As we mentioned in our response to the 2004 inspection report, we urge the Board to work closely with the firms to develop recommendations to establish the most effective approaches to auditing. We are committed to working with the Board in an effort such as this.

Respectfully submitted,

*GRANT THORNTON LLP*