

**Report on**  
**2004 Inspection of Grant Thornton LLP**

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

January 19, 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**

**Preface to Reports Concerning Annually Inspected Firms**

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("the Board") to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers. The Board's report on any such inspection includes this preface to provide context for information in the public portion of the report.

A Board inspection includes, among other things, a review of selected audits. If the Board inspection team identifies deficiencies in those audits, it alerts the firm to the deficiencies during the inspection process. Deficiencies that exceed a certain significance threshold are also summarized in the public portion of the Board's inspection report. The Board encourages readers to bear in mind two points concerning those reported deficiencies.

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements, or to take steps to prevent reliance on previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Second, the Board cautions against drawing conclusions about the comparative merits of these firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

**Notes Concerning this Report**

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

## **2004 INSPECTION OF GRANT THORNTON LLP**

In 2004, the Public Company Accounting Oversight Board ("PCAOB" or "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 consists of the Firm's comments, if any, on a draft of the report.<sup>1/</sup>

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

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

<sup>2/</sup> See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

## **PART I**

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

Members of the Board's inspection staff ("the inspection team") performed an inspection of Grant. The inspection team performed field work at Grant's National Office and at 12 of its 49 practice offices from May 2004 to October 2004, except with respect to one engagement review that was completed in March 2005. Appendix B to this report provides a description of the procedures the inspection team performed.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system. Appendix B to this report provides a description of the steps the inspection team took with respect to the review of audit engagements and the review of the seven functional areas related to quality control.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.<sup>3/</sup> It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

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

The scope of the inspection procedures performed included reviews of aspects of selected audits performed by the Firm. Those audits and aspects were selected

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

according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

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

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions,<sup>4/</sup> and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers. In some instances in which the inspection team identified GAAP departures, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.<sup>5/</sup>

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

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

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

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

#### Issuer A

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

##### (i) Securitization Gains and Retained Interests

Reported gains on the sales of certain loans, through securitization transactions, constituted more than 70 percent of the issuer's reported revenue. The Firm failed to perform sufficient audit procedures with respect to those reported gains and with respect to the value of the issuer's retained interests. The Firm did not test controls over the securitization process, and the Firm's substantive procedures were not sufficient. The Firm's substantive procedures for testing the gain amounts did not include tests of the cash proceeds or transaction costs and were based on its testing of the value of the issuer's retained interests, which also was not sufficient. The tests of the loan data, key assumptions, and models used to value the retained interests were not performed at the individual tranche or loan-type level; rather, various tranches or loan types were aggregated and the tests were performed at an aggregated level. The Firm also did not test, or did not include evidence in the work papers that it had tested, the data and assumptions used in the issuer's analysis of the relative fair values of the mortgage servicing rights.

In addition, the Firm failed to perform sufficient tests to determine whether the securitization transactions met the requirements of Statement of Financial Accounting Standards ("SFAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 140"), to be recognized as sales. The Firm did not test the issuer's controls over this process and only substantively tested

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

approximately three percent (three transactions) of the issuer's securitization transactions.<sup>7/</sup>

(ii) Loan Originations / Loan Inventory

The Firm's audit approach was to test and rely on the issuer's controls over the loan origination processes; however, the Firm failed to perform appropriate tests of the operating effectiveness of those controls. Although the Firm was aware of significant weaknesses in the issuer's access controls over processes that originated approximately half of the issuer's loans, the Firm did not address whether compensating controls, if any, addressed those weaknesses. In addition, the Firm's tests of these controls were very limited. The Firm should have increased the sample size as a result of the weaknesses in the access controls, but the Firm failed to do so. The sample covered only the first six months of the year, and the Firm did not perform other procedures to ensure controls were operating effectively during the second half of the year. Furthermore, the Firm failed to test the completeness of the population from which the sample was selected and could not explain to the inspection team how the sample was selected.

For the remaining loan origination process, the Firm concluded that controls were effective. The Firm based that conclusion on the premise that the issuer's internal audit department had tested the relevant controls. The Firm, however, was unable to demonstrate to the inspection team that the controls tested by internal audit were the appropriate controls to justify that conclusion.

The Firm's substantive audit procedures included sending negative confirmations for 250 outstanding loans at an interim date. One of the conditions for using negative confirmations is that the combined inherent and control risk assessment is low. The Firm, in its assessment of inherent risk as low, did not appropriately take into account the number of decentralized employees performing manual processes, the increase in the volume of loans processed, and the potential for errors and fraudulent transactions. As discussed above, the Firm failed to perform sufficient tests of controls to support a low control risk assessment. The Firm also did not test the completeness of the population from which it selected the 250 loans and was not able to demonstrate how the sample was selected and that each item had a known chance of selection.

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<sup>7/</sup> In 2005, the issuer restated certain 2003 quarterly financial statements to address the timing of the recognition of gains from securitization transactions.



The Firm's substantive audit procedures also included testing the roll-forward of the interim balances to the year-end balances. The Firm inappropriately relied on the controls over the loan origination processes when testing the roll-forward of the outstanding loans.

(iii) Financial Instruments / Hedge Effectiveness

The issuer used financial instruments extensively to manage interest rate risks. The Firm, however, failed to perform sufficient audit procedures with respect to the completeness, existence, and valuation of the financial instruments. The Firm applied a substantive audit approach that did not include testing the issuer's controls over financial instruments and hedging activities. Because the issuer used financial instruments extensively to manage its interest rate risk, the Firm was unable to reduce audit risk to an acceptably low level without testing the operating effectiveness of the issuer's controls.<sup>8/</sup>

In addition, the Firm's substantive procedures were insufficient in the following respects: (i) the Firm relied on reports it did not test; (ii) the populations from which the samples were selected were not tested for completeness; (iii) there was no apparent rationale for the sample sizes or the items selected, and the issuer's management picked the sample items for one test; (iv) an insufficient number of items was tested to conclude on the overall account balances; and (v) the procedures that were performed at interim dates were not updated to the year end.

Issuer B

In this audit, the Firm failed to evaluate the issuer's hedge designation, risk management objectives, and hedging strategies and to test the issuer's assessments of hedge effectiveness for its outstanding foreign currency futures contracts. As a result of questions raised by the inspection team, the Firm requested that the issuer provide documentation that supported hedge accounting treatment for the foreign currency

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<sup>8/</sup> AU Section 332, *Auditing Derivative Instruments, Hedging Activities and Investments in Securities*, paragraph 18 states, "In some circumstances, it may not be practicable or possible for the auditor to reduce audit risk to an acceptable level without identifying controls placed in operation by the entity or a service organization and gathering evidential matter about the operating effectiveness of those controls."

futures contracts. The issuer was unable to support that these contracts qualified for hedge accounting, and therefore, could not use hedge accounting.<sup>9/</sup>

#### Issuer C

In this audit, the Firm failed to identify certain departures from GAAP that it should have identified and addressed. The issuer had concluded that it was not required to disclose certain related party transactions, and the Firm had agreed. The inspection team, however, observed that these transactions, including advances to key members of management, should have been disclosed based on qualitative considerations.<sup>10/</sup> In addition, the Firm failed to audit the disclosure that certain other related party transactions were conducted at arm's length.

#### Auditing Banks (Three Issuers)

In three of the audits reviewed, deficiencies in the auditing of the allowance for loan losses, customer deposits and/or information technology controls resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinions. (Issuers D, E, and F)

##### (i) Allowance for loan losses

Each issuer's allowance for loan losses ("ALL") had three components: (i) a calculation based on historical losses for homogenous loans; (ii) adjustments for specific groups of loans; and (iii) unallocated reserves, which are not allocated to any specific loans, groups of loans, or specific risks. The second and third components, which are subject to significant management judgment, were greater than 40 percent of each issuer's ALL. The Firm did not perform sufficient audit procedures to conclude that the second and third components were appropriate since it did not test the reasonableness of the assumptions in management's and the Firm's own calculations.

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<sup>9/</sup> The issuer has restated its financial statements with respect to this matter.

<sup>10/</sup> The issuer subsequently disclosed that it had begun an internal investigation regarding certain related party transactions and certain public disclosures. The Firm then withdrew its opinion, indicating that the uncertainties described by the issuer caused the Firm to question the accuracy and reliability of the issuer's accounting and related disclosures.

(ii) Customer deposits

Customer deposits were at least 75 percent of each issuer's total liabilities. In each of these audits, the Firm did not perform sufficient audit procedures with respect to customer deposits.

The Firm's audit procedures for issuer D included scanning, inquiry, high-level analytical procedures, and reviewing a general ledger reconciliation. The Firm did not test controls related to customer deposits. The Firm's high-level analytical procedures did not meet the requirements for substantive procedures because the Firm failed to establish expectations and identify plausible relationships among the deposits and other accounts.

The Firm's audit procedures for issuer E included scanning, inquiry, high-level analytical procedures, reviewing a general ledger reconciliation, and positive confirmation of a sample of large deposits and negative confirmation of a sample of all other deposits. One of the conditions for using negative confirmations is that the combined inherent and control risk assessment is low. The Firm failed to perform, or failed to include in the work papers evidence that it had performed, any testing of controls over customer deposits. Negative confirmations, therefore, did not provide sufficient competent evidential matter. In addition, the Firm's high-level analytical procedures did not meet the requirements for substantive procedures because the Firm failed to establish expectations and identify plausible relationships among the deposits and other accounts.

With respect to issuer F, the Firm's tests of controls were not sufficient to reduce the Firm's substantive procedures. The Firm only tested the operating effectiveness of certain controls over customer deposits at a point in time, and the Firm did not test controls over certain major classes of transactions, such as wire transfers, automated teller machine transactions, and automated clearing house transactions. The Firm's audit procedures also included scanning, inquiry, high-level analytical procedures, reviewing a general ledger reconciliation, and negative confirmations. The negative confirmations did not provide sufficient competent evidential matter due to the deficiencies in the Firm's control testing, and the Firm's high-level analytical procedures did not meet the requirements for substantive procedures because the Firm failed to establish expectations and identify plausible relationships among the deposits and other accounts.

(iii) Information technology controls

The Firm's audit approach for issuers E and F included testing the operating effectiveness of information technology controls. The Firm's tests of the operating effectiveness of the issuer's access security and program change controls did not provide assurance that the controls operated effectively throughout the audit period.

Issuer G

(i) Variable interest entities

In this audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. This issuer disclosed that the adoption of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"), would not have a material effect on its financial condition or results of operations for 2003, and the Firm's FIN 46 analysis incorrectly concluded that the issuer's variable interest entities ("VIEs") did not need to be consolidated or disclosed. The inspection team noted that, as of December 31, 2003, the issuer should have consolidated one of its VIEs and should have disclosed the nature, purpose, size, activities, and maximum exposure to loss for six other VIEs to comply with the requirements of FIN 46.<sup>11/</sup>

(ii) Deferred tax asset valuation allowance

The issuer maintained a full valuation allowance against its net deferred tax asset ("DTA"). There was no evidence in the work papers to support that the Firm had evaluated the appropriateness of the valuation allowance. Various indicators suggested that elimination of the DTA valuation allowance would have been appropriate, including that the issuer had net income during each of the last three years.<sup>12/</sup>

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<sup>11/</sup> In connection with a revision to FIN 46, effective for 2004, all seven VIEs were consolidated in the issuer's financial statements beginning with the first quarter of 2004.

<sup>12/</sup> The issuer eliminated its DTA valuation allowance in the second quarter of 2004.

#### Issuer H

The Firm concluded that the issuer's IT general controls were designed effectively. The Firm assessed control risk as "below maximum" and thus reduced the extent of its detailed substantive audit procedures regarding the existence and cutoff of revenue. The Firm's control risk assessment was inappropriate because it was based primarily on inquiries and did not include any additional tests of the issuer's IT general controls or the application controls over the revenue process. Consequently, the extent of the Firm's detailed substantive audit procedures regarding the existence and cutoff of revenue was inadequate to obtain sufficient competent evidential matter.

#### Issuer I

In this audit, the Firm failed to evaluate whether the issuer's deferred tax assets were recoverable and whether the current classification for a portion of those assets was appropriate.

#### Issuer J

In this audit, the Firm failed to evaluate the recoverability of goodwill and long-lived assets. The Firm's goodwill impairment work papers included the issuer's analysis of the fair value of its reporting units. The issuer's analysis assumed it would develop new technologies and increase its market share for existing technologies. The Firm failed to evaluate the reasonableness of these assumptions, including the issuer's forecasted future net income in light of the issuer's operating losses over the previous three years. In addition, other than a signed audit program, there were no work papers relating to the impairment analysis for long-lived assets.

#### Issuer K

In this audit, the Firm's internal control testing and substantive procedures related to revenue were deficient. The Firm assessed control risk for revenue as "below maximum" in an environment that the Firm concluded had "pervasive weaknesses" in IT general controls. The nature and extent of the Firm's substantive procedures were not sufficient in a high control risk environment and inappropriately relied on system-generated information without testing the source data.

Issuer L

During the year under audit, this issuer recorded a write-down of inventory values in an amount equal to 34 percent of the issuer's loss before income taxes for the year. The Firm did not perform sufficient audit procedures related to this write-down because it failed to test the new values the issuer had assigned to the inventory, by comparing them to subsequent sales or otherwise obtaining evidence as to their appropriateness.

Issuer M

In this audit, the Firm failed to perform sufficient procedures to evaluate the goodwill impairment charge that the issuer recorded upon adoption of SFAS 142, *Goodwill and Other Intangible Assets* (SFAS 142). The amount of the cumulative effect of this change in accounting principles was more than 30 percent of the issuer's year-end retained earnings. The Firm did not have a person with the appropriate knowledge or skills in the valuation area review the issuer's estimate of the fair value of its reporting units. In addition, the Firm did not obtain evidence to support the issuer's critical assumptions, including why the same discount rate was appropriate for all of the issuer's reporting units.

Issuer N

In this audit, the Firm failed to perform adequate audit procedures to evaluate the issuer's inventory allowance for lower of cost or market adjustments and for slow moving and defective items. The issuer calculated the reserve by applying various percentages to certain components of its inventory. The Firm failed to (i) test these percentages, (ii) identify plausible relationships for the analytical procedures it performed, and (iii) obtain corroboration of the explanations provided by the issuer's management.

Issuer O

In this audit, the Firm failed in two respects to obtain sufficient competent evidential matter to support its audit opinion. First, the Firm did not evaluate the issuer's capitalized software costs for impairment in accordance with SFAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. Second, the Firm's assessment that inherent risk for the existence of accounts receivable was low did not take into account all relevant factors, including that the issuer was a new

client and one that the Firm had accepted late in the issuer's fiscal year, had operating losses and negative cash flow from operations for the past three years, and had previously restated its financial statements for revenue recognition issues. As a result, the Firm did not request a sufficient number of confirmations of customer balances.

**B. Review of Quality Control System**

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following seven functional areas: (1) tone at the top; (2) practices for partner evaluation, compensation, promotion, assignment of responsibilities and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances and arrangements; and commissions and contingent fees; (4) client acceptance and retention; (5) the Firm's internal inspection program; (6) practices for establishment and communication of audit policies, procedures and methodologies, including training; and (7) the supervision by U.S. audit engagement teams of the work performed by foreign affiliated and non-affiliated firms on foreign operations of U.S. audit clients. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

PART II, PART III, AND APPENDIX A OF THIS REPORT ARE NONPUBLIC  
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT



## **APPENDIX B**

### **THE INSPECTION PROCESS**

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

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

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

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenues, reserves or estimated liabilities, derivatives, income taxes, related party transactions, supervision of work performed by foreign affiliates, assessment of risk by the audit team, and testing and documentation of internal controls by the audit team. The inspection team also analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. For certain of the engagements selected for review, the inspection team reviewed written communications between Grant and the issuer's audit committee. With respect to certain of those engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

When the inspection team identified a potential issue, it discussed the issue with members of the audit engagement team and a Grant Regional Partner of Professional Standards. If the inspection team was unable to resolve the issue through this

discussion and any review of additional work papers or other documentation, the inspection team ordinarily requested the engagement team to consult with the Firm's National Office.

## 2. Review of Seven Functional Areas

The inspection team conducted the procedures related to the review of the seven functional areas primarily at Grant's National Office. With respect to six of the functional areas, the inspection team also conducted procedures at certain of the Firm's practice offices. The review of the seven functional areas was designed to provide a knowledge base on which to draw in planning future inspections, comparing firm practices, and measuring progress over time. The inspection team also performed procedures to identify possible defects in Grant's system of quality controls. A more detailed description of the scope with respect to each of the seven functional areas follows.

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

The inspection team evaluated the Firm's policies and procedures related to partner evaluation; partner compensation; nomination and admission of new partners; and discipline, assignment of duties, and termination of partners. The inspection procedures were designed to provide a basis for an assessment of whether the design of these processes, as documented and communicated, could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm.

The inspection team interviewed members of Grant'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 Grant that detailed information on each partner, including the partner's location, recent evaluation history, and compensation history. The inspection team also reviewed a sample of partners' personnel files, including files of newly admitted partners, partners who resigned or took early retirement, and partners who received bonus compensation.

b. Review of Independence Policies

The objectives of the inspection procedures in this area included gaining an understanding of and evaluating Grant's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer clients; Firm participation in business ventures, alliances, and arrangements; contingent fee arrangements; and the provision of services pursuant to Section 404 of the Act. To accomplish these objectives, the inspection team reviewed Grant's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed Grant's internal inspection program as it relates to monitoring compliance with Grant's independence policies and procedures; examined the Firm's independence consultation process, which included reviewing a sample of independence consultations; and reviewed information concerning Grant'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 Grant's independence policies, practices, and procedures.

For each of the engagements selected for review, the inspection team reviewed relevant information to identify any non-audit services performed for the issuer, including whether any of the services involved contingent fee arrangements; 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, 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 primary objectives of the inspection procedures in this area were to evaluate whether the Firm's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed Grant'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 Grant; 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, interviewed the audit partners and managers on those engagements concerning the reasons for continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks; and assessed whether the audit planning documentation incorporated the specific actions, if any, developed in response to any identified risks.

d. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of Grant's annual internal inspection program in enhancing audit quality, as well as to assess the Firm's compliance with the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance, and forms at Grant's National Office related to its internal inspection program, documentation of the results of the current year's inspection program, and steps taken by the Firm in response to those results. The inspection team also interviewed Grant's leadership concerning the process and effectiveness of its internal inspection program.

The inspection team reviewed and tested the conduct of the internal inspection program in 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 regional and office leadership and selected audit personnel concerning the internal inspection program. In addition, for a sample of the engagements that the internal inspectors had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with Grant any significant differences in the results of the inspection team's review and that of the Firm's internal inspectors.

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

The objectives of the inspection procedures in this area were to obtain an 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; to evaluate changes in audit policy that the firm had made in the past year; and to evaluate the content of the Firm's policies on Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*.

Toward those objectives, the inspection team reviewed documentation relating to the Firm's method for developing policies and procedures, as well as internal guidance and/or training materials distributed to audit personnel with respect to recent changes in requirements and to selected specific areas. The inspection team also evaluated the effectiveness of the design of Grant's processes for monitoring developments that could affect the Firm's audit policies, procedures, and methodologies.

f. Review of Policies Related to Foreign Affiliates and Non-Affiliates

The inspection team performed procedures in this area to evaluate the processes Grant uses to ensure that audit work performed by its foreign affiliated and non-affiliated firms 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 and non-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 Grant's policies and procedures related to its supervision and control of work performed by foreign affiliates and non-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 and non-affiliates on foreign operations of U.S. issuer clients. Finally, with respect to a sample of engagements selected from the engagements chosen for review, the inspection team reviewed the U.S. engagement team's supervision and control procedures concerning the audit work performed by the Firm's foreign affiliates and non-affiliates.

g. Review of Tone at the Top

The primary objective of the review of Grant'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 Grant's National Office. Such information included Grant's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, Grant's staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; descriptions of the Firm's financial structure and business plan; and agendas and minutes of the Firm's board of directors. In addition, the inspection team interviewed top management of the firm and six members of the firm's Executive Committee.

The inspection team conducted interviews at ten of the Firm's practice offices to obtain perspectives on communications from the Firm's leadership relating to audit quality and tone at the top. The inspection team interviewed members of the leadership at each of these offices, as well as certain audit partners and senior managers assigned to engagements that were reviewed. In addition, the inspection team conducted 15 focus group meetings in those offices to assess the participants' understanding of, among other things, the messages conveyed by the National Office, practice office leadership, and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top. Nine of these focus groups meetings consisted of audit senior managers and audit managers, and six were composed of audit senior accountants and audit staff.

## **APPENDIX C**

### **RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements, in the draft, that the Board corrects in the final report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.

December 28, 2005

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

**Re: Grant Thornton LLP Response to 2004 PCAOB Draft Report of Inspection**

Dear Mr. Diacont:

Grant Thornton LLP is pleased to submit its response to the Public Company Accounting Oversight Board's (the "PCAOB" or "the Board") draft Report on the 2004 Inspection of Grant Thornton LLP dated November 29, 2005. Our partners and personnel share the Board's mandate to improve audit quality. We fully support the inspection process and are committed to continuous quality improvements. We also want to acknowledge the dedication of the Grant Thornton partners and personnel in this effort.

We believe the Board's inspection process is critical to the profession's efforts to improve audit quality. We appreciate the inspection team's professionalism and the constructive dialogue about quality improvement opportunities that we had during the 2004 inspection of our 2003 audit engagements. While we have professional judgment differences on the nature, timing, extent and documentation on specific matters, and have discussed these with the staff, we appreciate the Board's comments and believe differing points of view can be a catalyst for meaningful change.

Grant Thornton understands the critical role of audit quality to reliable financial reporting and the importance of strengthening our quality systems. 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*. In each matter we assessed the Board's comments and took action, as appropriate. Those actions included performing additional procedures and/or adding appropriate currently dated documentation. The restatement involving certain 2003 quarterly financial statements and the withdrawal of Grant Thornton's report on another issuer were not a result of the inspection.

\* \* \* \* \*

As the result of the inspection of the eight largest accounting firms, the PCAOB inspection staff is in a unique position. These inspections give them an unprecedented, in-depth understanding of each of the firms' audit methodologies, policies and procedures. In 2002 we issued a Five Point Plan to Restore Public Trust in the Accounting Profession. As part of that plan, we recommended that the AICPA coordinate a review of the major accounting firm's audit methodologies so that best practices could be determined and shared. Our



sincere hope is that the PCAOB, given the knowledge they now have, will work closely with the firms and develop timely recommendations to establish the most effective approaches to auditing. This would certainly serve the public interest. We are committed to working with the Board in this effort.

Respectfully submitted,

*GRANT THORNTON LLP*