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Report on 2005 Inspection of KPMG LLP

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

January 11, 2007

**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. 104-2007-002

Preface to Reports Concerning Annually Inspected Firms

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

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

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

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



that year. Such weaknesses may emerge in varying degrees at different firms in different years.

During 2005, the Board monitored the implementation of the provisions of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2") by annually inspected U.S. firms. Among other things, that monitoring included Board staff meetings with these firms to discuss their methodology and to discuss opportunities to enhance the effectiveness and efficiency of audits of internal control. As the Board has previously stated, the Board believes that audits performed under the difficult circumstances of the first year of implementation of AS No. 2 were often not as efficient as the standard intends, and as the Board expects them to be in future years. The primary reasons for this failure to achieve expected efficiencies are described in the Board's Report on the Initial Implementation of Auditing Standard No. 2 ("the Report").^{1/} 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.

^{1/} 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 KPMG LLP

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

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

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{3/} 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.

^{2/} 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.

^{3/} 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 June 2005 to February 2006. The inspection team performed field work at the Firm's National Office and at 14 of its approximately 89 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 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.^{4/} 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.

^{4/} 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.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of selected audits of financial statements and of internal control over financial reporting performed by the Firm. Those audits and aspects were selected according to the 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 one case, an error that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the Firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claims to have performed the procedure. PCAOB Auditing Standard No. 3 ("AS No. 3"), in effect for most of the audits reviewed in the inspection,^{5/} 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.^{6/} 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,^{7/}

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

^{6/} See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

^{7/} 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*

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.^{8/}

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. In some of those audits, that conclusion followed from the omission, or insufficient performance, of a single procedure, while other audits included more than one such failure. The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis (without identifying the issuers), along with a deficiency observed in the Firm's interim review of financial statements for a quarter in a fiscal year that was incomplete at the time of the inspection.^{9/}

Issuer A

The issuer was unable to obtain the necessary support for a deduction on its tax return and, accordingly, it did not recognize any of the tax savings in its 2004 financial statements. After the issuer's year end, the issuer's tax advisors issued a tax opinion letter, and the issuer recognized 100 percent of the tax savings in the first quarter of 2005. The Firm evaluated the tax opinion letter and agreed with the issuer's

(both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

^{8/} 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.

^{9/} 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.

determination that it could recognize the entire tax savings. In doing so, however, the Firm failed to identify or appropriately address the fact that, in light of certain factors, not all of the tax savings could be recognized under GAAP.^{10/}

Issuer B

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

- In 2004, the issuer determined that, in prior years, it had incorrectly reduced cost of sales for vendor allowances related to one contract. The issuer corrected a portion of the error in its 2004 financial statements, but it did not correct the remainder of the error. The Firm failed to evaluate whether additional errors existed for this and other similar contracts.^{11/} Furthermore, the Firm failed to include the uncorrected portion of the error on the Summary of Unadjusted Audit Differences (“SUAD”).^{12/}
- The issuer recorded significant impairment charges during 2004 and announced a plan to close certain of its locations during the fourth quarter of 2004. A significant factor influencing the issuer’s decision was the effect of competition. In preparing analyses of estimated future cash flows to identify possible impairments for each of its remaining locations, the issuer relied primarily upon historical cash flows. The Firm did not evaluate whether the issuer’s reliance on historical cash flows to produce these estimates was appropriate given the effect of competition.

^{10/} Subsequent to the inspection, the issuer and the Firm, upon further review and analysis, determined that the majority of the savings should not have been recognized in the first quarter of 2005, and the issuer has restated its previously issued quarterly financial statements based on this determination.

^{11/} Subsequent to the inspection, the issuer corrected this and similar errors in its 2005 financial statements.

^{12/} The SUAD is a schedule of uncorrected errors to be communicated to the audit committee, included in the management representation letter, and evaluated individually and in the aggregate for materiality.

Issuer C

The issuer changed its method of accounting for certain inventories. A domestic subsidiary of the issuer had acquired these inventories from one of the issuer's international subsidiaries, whereas previously the domestic subsidiary had manufactured similar goods or had acquired them from an unrelated party. The change in the method of accounting for inventories had a negligible effect on the issuer's income before taxes; however, it had the effect of reducing the issuer's income taxes by over ten percent and increasing its net income by over three percent. The issuer did not disclose the change in the method of accounting, and it included the tax savings, along with other matters, in a line entitled "lower taxes on foreign results" in the tax footnote to the financial statements.

There is no evidence in the audit documentation, and no persuasive other evidence, that the Firm properly evaluated whether the issuer's lack of disclosure of the change in the method of accounting complied with Accounting Principles Board Opinion No. 20, *Accounting Changes*, and whether the issuer's lack of separate disclosure of the tax savings complied with SEC Regulation S-X Rule 4-08(h).

Issuer D

In this audit, the issuer calculated depreciation for 2004 for most of its property, plant, and equipment using the composite method. Under the composite method, the issuer estimates the average remaining useful lives (ARLs) for specific groups of assets. The issuer used the same ARLs in its 2004 calculation as it had used in its 2003 calculation. The Firm failed to obtain evidential matter that addressed whether the ARLs had changed from the previous year or to evaluate whether the use of the prior year's ARLs, rather than the current year's ARLs, had a material effect on the issuer's 2004 financial statements.

Issuer E

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

- The issuer determined that its allowance for doubtful accounts had been understated in prior years, due to the inclusion of certain credit balances in its accounts receivable. The issuer corrected the error in its 2004 financial

statements. Because the Firm incorrectly concluded that the adjustments represented a change in estimate, the Firm failed to evaluate whether the error had a material effect on prior years' financial statements. In addition, the Firm did not perform procedures beyond inquiry to obtain corroboration of management's assertion regarding the amount of the error.

- The Firm failed to evaluate modifications to seven lease agreements sufficiently to be able to conclude whether they were operating leases or capital leases. The Firm based its evaluation on the issuer's internal analyses without testing certain of the issuer's critical assumptions.^{13/}
- The Firm failed to perform sufficient alternative procedures after concluding that confirmation of accounts receivable would not be effective. The Firm's alternative procedures were limited to analytical procedures, and the Firm did not obtain corroboration for management's explanations of significant differences from the Firm's expectations.
- The Firm's journal entry testing to address the risk of fraud did not comply with AU 316, *Consideration of Fraud in a Financial Statement Audit* ("AU 316"), because the Firm did not test entries recorded in the issuer's general ledger, and because the Firm failed to test the completeness of the list of post-closing journal entries provided by the issuer and used by the Firm for its testing.
- The Firm's analytical procedures to test operating expenses did not meet the requirements for substantive analytical procedures because, in one procedure, the Firm did not set a threshold for investigation and evaluation that allowed it to achieve the desired level of assurance and, in another procedure, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained corroboration of

^{13/} Subsequent to the inspection staff's procedures, the issuer restated its 2003, 2004, and 2005 annual financial statements, and its quarterly financial statements for the first quarter of 2006, to address a matter not reviewed in the inspection. At the same time, the issuer also restated its accounting for these leases.

management's explanations for significant differences from the Firm's expectations.

Issuer F

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

- The Firm's audit procedures to test revenue consisted primarily of analytical procedures. The Firm analyzed revenue at the company-wide level, even though the issuer operated in more than 250 locations and provided different products and services. The Firm's analytical procedures were therefore not disaggregated to a level that would provide the Firm with reasonable assurance of detecting misstatements that are material, individually or when aggregated with other misstatements. Further, the Firm failed to seek corroboration of management's explanation for a difference from the Firm's expectation that was greater than its threshold of significant differences.
- To test accounts receivable, the Firm performed substantive analytical procedures rather than sending confirmation requests. These analytical procedures consisted primarily of comparing reported subsequent cash receipts to the Firm's expectation of subsequent cash receipts. The reported subsequent cash receipts differed from the Firm's expectation by an amount greater than the Firm's established threshold of significant differences. The Firm revised its expectation based upon its discussions with the issuer. The reported cash receipts were within this revised expectation; however, the Firm failed to obtain corroboration of management's explanations that resulted in the revised expectation. The Firm also tested a sample of subsequent cash receipts. The Firm did not compare the sample items to the recorded accounts receivable, nor was the sample size sufficient to provide the Firm with the necessary level of assurance regarding the accuracy of the recorded accounts receivable.
- The issuer maintained inventory at numerous locations and did not have a perpetual inventory system. The issuer performed one complete inventory count at each location per year. The Firm observed certain of these

inventory counts at various times during the year. The Firm did not test inventory transactions between the dates of the interim physical inventory observations and year end, nor did it compare the interim balances with the year-end inventory balances; rather, its procedures were limited to comparing the inventory balances at year end with those at the prior year end.

Issuer G

The issuer prepared a goodwill impairment analysis for each of its four units at year end, using a third-party valuation specialist. The issuer concluded, and the Firm agreed, that goodwill was not impaired. The specialist relied in part on financial forecasts that the issuer had prepared. The forecasts for two of the units indicated significant improvements in cash flows from historical amounts. The future revenue growth was inconsistent with the issuer's historical performance, and the audit documentation indicated that previous forecasts for these units had been adjusted downwards. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the revenue growth assumptions that the issuer had used in the financial forecasts.

Issuer H

The Firm's procedures to test a significant portion of the issuer's revenue consisted primarily of tests of controls, high-level analytical procedures, clerical reconciliation procedures, journal entry testing, and testing a sample of transactions that were recorded in the last five days of the year for proper sales cut-off. Given the significant risk of material misstatement associated with revenue, the audit evidence the Firm obtained was not sufficient because the analytical procedures did not meet the requirements for substantive analytical procedures, as there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had developed expectations, established a threshold for further investigation, and obtained corroboration of management's explanations of significant unexpected differences. In addition, the Firm concluded that the confirmation of accounts receivable at certain of the issuer's locations would not be effective, and relied upon the results of the tests of controls, sales cut-off tests, certain analytical procedures that did not meet the requirements for substantive analytical procedures, and certain procedures applied to the allowance for doubtful accounts for its testing of these accounts receivable. The Firm failed, however, to examine subsequent cash receipts, shipping documents, or

other evidence that would allow the Firm to evaluate the existence of accounts receivable.

Issuer I

Sales of land represented approximately 26 percent of the issuer's revenue for the year. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the sales contracts to determine whether the criteria for revenue recognition had been met.

Issuer J

In this audit, the Firm concluded that the confirmation of accounts receivable at a significant division of the issuer would not be effective. The Firm failed to perform appropriate alternative procedures because the Firm did not select a sample of the accounts receivable to test; rather, it selected a sample of recorded cash receipts. As a result, the Firm failed to test accounts receivable that had not been collected subsequently.

Issuer K

The issuer had retained a valuation consultant to assess the value of a subsidiary as of the end of the year and, based on that valuation, the issuer had concluded that an adjustment to the subsidiary's carrying value was not required. The valuation consultant had used various data and assumptions that the issuer had provided, including increasing projected revenues, increasing projected EBITDA (earnings before interest, taxes, depreciation, and amortization), decreasing projected capital expenditures, and unchanging projected working capital requirements. The Firm failed to perform sufficient procedures to test the data and assumptions that the issuer had provided to the valuation consultant.^{14/} The Firm's procedures consisted primarily of obtaining and relying upon representations from management regarding the appropriateness of the data and assumptions without assessing their reasonableness.

^{14/} During the third quarter of the following year, the issuer committed to sell the subsidiary for approximately one-third of its carrying value and, as a result, recognized an impairment charge equal to more than twice the issuer's reported net loss for the year.

For example, many of management's assumptions were not based on the issuer's recent results, which were significantly lower than those for the period from which the data and assumptions were derived, due to the discontinuance of a major product line and the loss of a contract with a major customer.

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, 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) the Firm's internal inspection program; (6) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (7) the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. 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



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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, intangible assets, 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. With respect to certain engagements, the inspection team reviewed written communications between the Firm and the issuer's audit committee, and 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 Department of Professional Practice ("DPP"). 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 Seven Functional Areas

The inspection team conducted the procedures related to the review of the seven functional areas primarily at the Firm's National Office. With respect to six of the seven 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 seven 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 seven members of the Firm's leadership at its National Office, as well as members of leadership and audit partners in practice offices, regarding these topics. In addition, the inspection team analyzed schedules provided by the Firm that detailed information on each partner, including the partner's office location, recent evaluation history, and compensation history. The inspection team also reviewed a sample of partners' personnel files, including files of newly admitted partners and partners who resigned or took early retirement.

b. Review of Independence Policies

The objectives of the inspection procedures in this area included evaluating the Firm's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer audit clients; Firm participation in business ventures, alliances, and arrangements; commissions and contingent fee arrangements; personal financial interests and the relationships of Firm professionals with issuer audit clients; and the provision of non-audit services related to issuer audit clients' compliance with Section 404 of the Act. To accomplish these objectives, the inspection team reviewed the Firm's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed the Firm's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures; tested the Firm's independence consultation process; and reviewed information concerning the Firm's existing business ventures, alliances, and arrangements, as well as the Firm's process for establishing such enterprises. The inspection team also interviewed numerous National Office and practice office personnel regarding the Firm's independence policies, practices, and procedures.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, reviewed relevant information to identify any non-audit services performed for the issuer, including whether any of the services involved commissions or contingent fee arrangements; to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement; and to determine whether the Firm was involved in any business ventures, alliances, or arrangements with the issuer. In addition, for the sample, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

c. Review of Client Acceptance and Retention Policies

The objectives of the inspection procedures in this area were to evaluate whether the Firm's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed the Firm's policies, procedures, and forms related to client acceptance and continuance; evaluated documentation related to new clients and to clients that had recently changed auditors from the Firm; and interviewed members of the Firm's leadership.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, evaluated whether the client acceptance or continuance documentation was completed and approved in accordance with Firm policies; interviewed the audit partners 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 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 eight practice offices where the Firm had conducted internal inspections. These procedures included reading the inspectors' comments and interviewing Firm leadership 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 and reviewed certain aspects of the audit work papers.

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

The objectives of the inspection procedures in this area were to update the inspection team's understanding of the Firm's processes for establishing and communicating audit policies, procedures, and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; and to evaluate changes in audit 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.

f. 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. Except for one issuer where the inspection team requested access, which the Firm provided, the inspection team did not inspect the audit work of

foreign affiliates; rather, the inspection procedures in this area were limited to the supervision and control exercised by the U.S. engagement team over such work.

To accomplish this objective, the inspection team reviewed 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 and analyzed audit guidance related to planning and administering multi-location engagements. In addition, the inspection team interviewed members of the Firm's leadership with responsibility for oversight of the work performed by foreign affiliates on foreign operations of U.S. issuer clients. Finally, with respect to a sample of 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.

g. Review of Tone at the Top

The objective of the review of the Firm's "tone at the top" was to assess whether actions and communications by the Firm's leadership demonstrate a commitment to audit quality and compliance with the Act, the rules of the Board, the rules of the SEC, and PCAOB standards in connection with the Firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at the Firm's National Office. Such information included the Firm's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, the Firm's staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; and agendas and minutes of the Firm's board of directors and management committee. In addition, the inspection team interviewed numerous members of the Firm's leadership team. The inspection team also 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.^{15/}

^{15/} In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of the Firm's response is made publicly available.



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December 27, 2006

Mr. George H. Diacont
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Response to Public Company Accounting Oversight Board (PCAOB) Draft Report (Draft Report) on 2005 Inspection of KPMG LLP

Dear Mr. Diacont:

We appreciate the opportunity to review and comment upon the PCAOB's Draft Report on its 2005 inspection of KPMG LLP dated November 27, 2006. We know that we share a common objective – serving our capital markets by performing high quality audits – and believe that the PCAOB's inspection process provides valuable input for our mutual consideration.

We appreciate the professionalism of the PCAOB inspection staff and the role the PCAOB plays in improving audit quality. We also want to recognize the professionalism and diligence displayed by the partners and employees of KPMG as they continuously strive to execute high quality audits.

Just as auditors use their judgment to determine the auditing procedures to be performed, the PCAOB inspection staff members' observations are based upon their assessment of audit risk and financial statement materiality. While we may have differing views as to the nature and extent of necessary auditing procedures, resulting conclusions, and/or required documentation in specific circumstances, we recognize that judgments are involved in both the performance of an audit and the subsequent inspection process, and we view the PCAOB's comments as helpful and give each careful and thoughtful consideration.

With respect to the findings identified in Part I of the Draft Report, consistent with PCAOB professional standards and KPMG policies and procedures, we have addressed the matters identified by the PCAOB. As previously communicated to the PCAOB staff, in certain instances we have performed additional audit procedures and/or improved the documentation in the audit files. In other instances, we concluded that no additional actions were necessary.

* * *

We believe that a constructive regulatory relationship is vital to enhancing public confidence in the audit profession and strengthening our capital markets. We have made, and will continue to make, improvements in our quality controls that relate to audit performance. In addition, we



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continue to implement governance and structural changes designed to reflect the highest ethical standards and create an environment where our professionals clearly understand that their highest priorities are integrity and professional excellence.

KPMG is committed to continually improving our firm and the profession and working constructively with the PCAOB to improve audit quality. Thank you for your assistance in this effort.

Very truly yours,

KPMG LLP