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**Report on**  
**2005 Inspection of KPMG LLP (Canada)**

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

**February 22, 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. 104-2007-025



### **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. 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 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.



### 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 (Canada)

In 2005, the Board conducted an inspection of KPMG LLP (Canada) ("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 and portions of Part IV of the report. Part IV of the report 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 routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

<sup>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 the Firm from April 2005 to September 2005.<sup>3/</sup> The inspection team performed field work at the Firm's national office in Toronto ("National Office") and at six of its 34 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.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.<sup>4/</sup> It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

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

The scope of the inspection procedures performed included reviews of aspects of selected audits of financial statements 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.

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<sup>3/</sup> The Board's inspection was conducted in cooperation with the Canadian Public Accountability Board.

<sup>4/</sup> When the Board becomes aware that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies. Those 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. With respect to those audits required to comply with PCAOB auditing standards,<sup>5/</sup> Auditing Standard No. 3, in effect for most of such audits reviewed in the inspection,<sup>6/</sup> provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence.<sup>7/</sup> For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

When deficiencies are identified after the date of the audit report with respect to an audit conducted in accordance with PCAOB auditing standards, 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>8/</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.

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<sup>5/</sup> Some of the Firm's issuer audit clients file reports with the Commission under the multijurisdictional disclosure system, which, as implemented, permits the filing of financial statements that have been audited in accordance with Canadian generally accepted auditing standards rather than PCAOB auditing standards.

<sup>6/</sup> Auditing Standard No. 3, *Audit Documentation*, applies to audits with respect to fiscal years ending on or after November 15, 2004.

<sup>7/</sup> See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

<sup>8/</sup> See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. In some of those audits, that conclusion followed from the omission, or insufficient performance, of a single procedure, while other audits included more than one such failure. The deficiencies that reached this degree of significance are described below (without identifying the issuers).<sup>9/</sup>

#### Issuer A

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

- The Firm failed to adequately audit estimated recoverable reserves, which affect the issuer's depreciation, depletion, and amortization expenses, its estimated site closure and reclamation costs, and its evaluation of impairment. The Firm placed reliance on specialists employed by the issuer and on work performed by outside specialists in the prior year. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed the specialists' qualifications, understood the nature of the specialists' work, assessed the specialists' relationship to the issuer, understood the methods and assumptions used by the specialists, or evaluated whether the specialists' findings supported the related assertions in the financial statements.
- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed adequate procedures to audit the components of the site closure and reclamation costs liability or the changes therein. For significant elements of the calculation of this estimate, the Firm relied on the results of inquiries of management, the testing of calculations for mathematical accuracy, and the tracing of information from detailed to summary schedules. The Firm, however, did not seek to obtain corroboration of management's representations or test the significant assumptions used by management to calculate the estimate.

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<sup>9/</sup> The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed adequate procedures to ensure that certain costs incurred, including production, mine development, pre-production, and exploration costs, were allocated to the appropriate asset and expense accounts. The Firm's procedures were limited to testing for evidence of review and approval of monthly budget variance reports and to high-level analytical procedures.

#### Issuer B

The issuer earned approximately eight percent of its revenues from certain long-term projects. The projects were accounted for on the percentage of completion basis, and the revenue and estimated profits from these projects were recorded as costs were incurred. The Firm tested the costs incurred throughout the year, as these costs were used to determine the recorded revenues and profits. The Firm, however, failed to evaluate the reasonableness of the total estimated costs on each project to determine whether the estimated total profit on the project, and therefore the recorded revenues and profits, were reasonable.

#### Issuer C

The inspection team identified deficiencies in the Firm's auditing of two business combinations that were completed during the year. For the first combination, the issuer retained an independent specialist to value, for purchase accounting purposes, the assets and liabilities acquired. Using the specialist's valuations, which were based on revenue and margin projections provided by management, the issuer assigned approximately 42 percent of the purchase price to identifiable intangible assets. The Firm did not test the reasonableness of the revenue and margin projections that the issuer had provided to the specialist.

The purchase price for the second combination was allocated to the acquired assets based on the results of management's estimation process. The Firm's work papers state that this estimation process took into account several methods of valuing the assets, both objective and subjective. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested several of the methods that factored into management's analysis in order to evaluate the appropriateness of the values assigned. Nor did the Firm address the appropriateness of the assigned values in relation to the estimated replacement values included in the work papers. In addition, the issuer recorded certain intangible values representing the estimated value of customer relationships. There was no evidence in the audit

documentation, and no persuasive other evidence, that the Firm had tested the valuation of these intangible assets.

#### Issuers D and E

Fixed assets represented approximately 87 percent and 59 percent of total assets for the issuers, respectively. Fixed asset additions during the period under audit represented approximately eight percent and 83 percent of the respective issuer's fixed assets. The Firm failed to perform substantive tests of the additions of oil and gas extraction assets, which constituted virtually all of the additions, with the exception of those acquired in business combinations.

#### B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies, and procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following eight functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) the supervision by the Firm's audit engagement teams of the work performed by non-Canadian affiliates on non-Canadian operations of the Firm'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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PARTS II AND III OF THIS REPORT ARE NONPUBLIC  
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

**PART IV**

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

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.<sup>10/</sup>

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<sup>10/</sup> In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of the Firm's response is made publicly available.



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

January 24, 2007

Dear Mr. Diacont:

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

We are pleased to respond to the PCAOB draft report dated December 22, 2006 on the 2005 inspection (2005 PCAOB Report) of KPMG Canada.

KPMG Canada is committed to conducting the highest quality audits and to prompt and effective response to constructive observations and recommendations. We are making and will continue to make improvements in our audit methodology, quality control processes and engagement execution and will maintain our full cooperation with the PCAOB as it continues its ongoing inspection process.

Just as auditors use their judgment to determine the auditing procedures to be performed, the PCAOB inspection staff's 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 audit procedures, resulting conclusions, and/or required documentation in specific circumstances, we recognize that judgments are involved in both the performance of an audit and subsequent inspection process, and we view the PCAOB's comments as very helpful and give each careful and thoughtful consideration.

At the time of PCAOB's 2005 inspection, KPMG Canada was the only firm outside the United States with over 100 SEC registrant audit clients and therefore subject to an annual inspection by the PCAOB. In Canada, the Canadian Public Accountability Board (CPAB) was formed in 2003 to carry out inspections of Canadian accounting firms. All major accounting firms in Canada, including KPMG Canada, have been subject to annual CPAB inspections, starting in 2004. The 2005 PCAOB inspection of KPMG Canada was carried out in conjunction with CPAB's 2005



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inspection. Generally the matters raised in the 2005 PCAOB Report are matters that were also raised and responded to by KPMG Canada in the CPAB 2005 report, which was previously provided in final form to KPMG Canada by CPAB.

With respect to the findings identified in Part I of the 2005 PCAOB Report, we have addressed each of the matters identified by the PCAOB. In certain instances we have performed additional audit procedures and/or improved aspects of the audit documentation in the audit files. In other instances, we concluded that no additional actions were necessary. In all instances, our original audit conclusions remained unchanged.

We appreciate the professionalism of the PCAOB inspection staff and the role the PCAOB plays in improving audit quality. While the requirement to have two separate inspections invariably leads to some duplication of effort, we recognize the efforts of both the PCAOB and CPAB towards performing their inspections in a coordinated manner. We also want to recognize the professionalism and diligence displayed by the partners and employees of KPMG Canada as they continuously strive to execute high quality audits.

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

Very truly yours

A handwritten signature in black ink that reads 'KPMG LLP'.