

Report on
2009 Inspection of Ernst & Young LLP
(Headquartered in New York, New York)

Issued by the
Public Company Accounting Oversight Board

July 2, 2010

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 ("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.



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.



2009 INSPECTION OF ERNST & YOUNG LLP

In 2009, the Board conducted an inspection of the registered public accounting firm Ernst & Young LLP ("E&Y" or "the Firm"). The Board is 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.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} 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.

^{1/} 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.

^{2/} 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") conducted primary procedures for the inspection from October 2008 to October 2009. The inspection team performed field work at the Firm's National Office and at 30 of its approximately 80 U.S. practice offices.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.^{3/} 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 and the review of certain firm-wide quality control processes.

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.

^{3/} This focus on weaknesses and deficiencies necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

^{4/} 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'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 58 audits performed by the Firm. The scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies.^{5/} Those deficiencies included a failure by the Firm to identify or appropriately address an error in the issuer's application of GAAP. 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, *Audit Documentation* ("AS No. 3") 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/} 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.

^{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*, 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.^{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 or internal control over financial reporting ("ICFR"). The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis.

Issuer A

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

- The Firm failed to test indicators of fair value, such as broker quotes, that the issuer used to determine the fair values of certain financial liabilities, and failed to adequately test the models, inputs, and indicators of fair value that the issuer used to determine the fair values of certain financial assets. Specifically, the Firm failed to identify certain existing flaws in the models that the issuer used, and failed to evaluate whether the issuer's data were reasonable and not inconsistent with market information.
- The Firm failed to adequately test the issuer's loan loss reserves related to certain loans held for investment. Specifically, the Firm failed to reconcile certain values used in the issuer's models with industry data, failed to test the recovery rates used in the issuer's calculation, and failed to test the qualitative components of the reserves.

(both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T), and PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* ("AS No. 5"), ¶ 98.

^{8/} The Board inspection process generally did not include review of such additional procedures or documentation, although future Board inspections of the Firm may, as appropriate, include further review of any of these matters.

- The Firm failed to identify an existing material weakness in internal controls related to certain of the issuer's valuation processes.^{9/}

Issuer B

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

- The Firm's level of reliance on internal controls when testing revenue was not supported adequately because the Firm failed to identify and test certain relevant controls over the existence and valuation assertions.
- This issuer processes its revenue transactions using a web application, and uses data from this application to record its revenue. The Firm failed to test the completeness and accuracy of certain significant data generated and maintained through this web application.

Issuer C

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

- The Firm failed to perform sufficient procedures to test the issuer's allowance for loan losses ("ALL"). The issuer determined the general portion of its ALL estimate, which represented a significant portion of the ALL, using certain factors such as loan grades. Data for this calculation were obtained from information technology systems that reside at a third-party service organization. The Firm relied on these systems, but it failed to test the information-technology general controls ("ITGCs") over certain of these systems, and it failed to test certain of the application controls over these systems. Further, the Firm's testing of the controls over the assignment and monitoring of loan grades was insufficient, as the Firm failed to assess the

^{9/} The Firm identified this failure in the course of performing additional procedures following the inspection team's observations on aspects of the Firm's audit of the issuer's valuation of its financial assets and liabilities. The Firm revised its opinion on the issuer's ICFR related to the matter discussed here.

competence of the individuals performing the control on which it relied. Further, because it selected a sample of which a majority of the items had not been subject to the control, it tested only a relatively small number of items when testing the control.

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of certain assumptions that the issuer used to determine the fair value of certain hard-to-price securities.

Issuer D

In this audit, the Firm failed to sufficiently audit inventory in the following respects-

- The Firm failed to sufficiently test the costing of work-in-process and finished goods inventory. Specifically, the Firm's tests of controls over the costing of such inventory were limited to verifying that management reviewed and approved the cost allocation factors, without evaluating the review process that provided the basis for management's approval. Further, the Firm did not test the completeness and accuracy of certain underlying data that the issuer used in the cost allocation process. Finally, the Firm's substantive procedures were insufficient because, for certain of its analytical procedures, the Firm did not use data with predictable relationships to the recorded amounts and, for others, the Firm failed to develop expectations that were precise enough to provide the necessary level of assurance.
- The Firm failed to identify and test internal controls over the issuer's assertion that its raw material inventory was recorded at its average cost and accordingly failed to establish a basis for its reliance on controls in designing its substantive audit procedures in this area. The Firm's substantive testing did not address whether the issuer's raw material inventory was carried at its average cost, as the Firm reviewed only the most recent invoice for the items it selected for testing.

Issuer E

In this audit, the Firm failed to test the issuer's assertion that certain long-lived assets were not impaired despite the issuer's current and historical operating and cash flow losses.

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 five areas (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining clients, including the application of the Firm's risk-rating system; (4) processes related to the Firm's use of audit work that the Firm's foreign affiliates perform on the foreign operations of the Firm's U.S. issuer audit clients; and (5) the Firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to weaknesses in quality control. 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 by the Firm with applicable requirements related to auditing issuers. This process included reviews of components of selected issuer audits completed by the Firm. These reviews were intended both to identify deficiencies, if any, in those components of the audits and to determine whether the results of those reviews indicated deficiencies in the design or operation of the Firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

1. Review of Selected Audits

The inspection team reviewed aspects of selected audits of financial statements and ICFR, which it chose 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 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, revenue, fair value measurements, financial instruments, income taxes, reserves or estimated liabilities, inventories, consideration of fraud, related party transactions, supervision of work performed by foreign affiliates, and assessment of risk by the engagement team. The inspection team also analyzed potential adjustments to the issuer's financial statements that were identified during the audit but not corrected. For certain selected engagements, the inspection team reviewed written communications between the Firm and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

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.

2. Review of Firm Management and Monitoring Processes Related to Audit Quality Control

The inspection team's approach to its review of the Firm's system of quality control was intended to further its understanding of how the Firm manages audit quality, so as to enhance its basis for assessing, in this year and in future years, whether that system is appropriately designed and implemented to achieve the goal of conducting audits that are in compliance with applicable standards. The inspection team also continued its assessment of the Firm's processes and controls that relate to certain specific functional areas that relate to audit performance. The overall approach was designed to identify possible defects in the design or operation of the Firm's system of quality control, while also continuing and enhancing the evaluation of the Firm's ability to respond effectively to indications of possible defects in its system of quality control.

a. Review of Management Structure and Processes, Including the Tone at the Top

The objectives of the inspection procedures in this area were (a) to update the inspection team's understanding of how the Firm's management is structured and operates the Firm's business, and the implications that the management structure and processes have on audit performance and (b) to continue assessing whether actions and communications by the Firm's leadership – the Firm's "tone at the top" – demonstrate a commitment to audit quality. Toward those ends, the inspection team interviewed members of the Firm's national, regional, and local leadership to obtain an understanding of any significant changes in the Firm's approach to, and processes for, its management, including the various management committees or other mechanisms, formal or informal, that relate to assessing and monitoring audit performance, or that otherwise affect audit performance. The inspection team also obtained and reviewed significant management reports and documents, as well as information regarding financial metrics and the budget and goal setting processes that the Firm uses to plan for, and evaluate the success of, its business.

- b. Review of Practices for Partner Management, Including Allocation of Partner Resources and Partner Evaluation, Compensation, Admission, and Disciplinary Actions

The objectives of the inspection procedures in this area were (a) to continue to assess whether the design and application of the Firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm; (b) to assess the Firm's quality controls over the allocation of its partner resources; and (c) to identify and assess the accountability and responsibilities of the different levels of Firm management with respect to partner management. The inspection team interviewed members of the Firm's management and also reviewed and evaluated documentation regarding certain of these topics. In addition, the inspection team reviewed a sample of partners' personnel files, including files of partners who resigned or took early retirement and partners who had significant negative inspection results from recent internal and PCAOB inspections.

- c. Review of Policies and Procedures for Considering and Addressing the Risks Involved in Accepting and Retaining Clients, Including the Application of the Firm's Risk-Rating System

The objectives of the inspection procedures in this area were to continue to assess whether the Firm appropriately considers and addresses the risks involved in accepting and retaining clients in the particular circumstances and to assess the Firm's responses to the risks identified, including the extent to which an observable link exists between the identified risks of material misstatement and the audit procedures performed. Toward those objectives, the inspection team obtained an understanding of any changes in the acceptance and retention processes and evaluated the Firm's policies and procedures relating to the Firm's risk-rating systems. The inspection team interviewed members of the Firm's management and selected certain issuer audits to (a) evaluate compliance with the Firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the client and (b) observe whether the audit procedures were responsive to the risks identified during the process.

- d. Review of Processes Related to the Firm's Use of Audit Work that the Firm's Foreign Affiliates Perform on the Foreign Operations of the Firm's U.S. Issuer Audit Clients

The inspection team performed procedures in this area with respect to 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 applicable standards. For its procedures in this area, the inspection team reviewed the Firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the operations of U.S. issuer clients, reviewed available information relating to the most recent foreign affiliated firms' internal inspections, interviewed members of the Firm's leadership, and reviewed the U.S. engagement teams' supervision and control procedures concerning the audit work that the Firm's foreign affiliates performed on a sample of audits. The inspection team also reviewed, on a limited basis, certain of the audit work performed by the Firm's foreign affiliates on the foreign operations of U.S. issuer clients.

- e. Review of the Firm's Processes for Monitoring Audit Performance, Including Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance, Independence Policies and Procedures, and Processes for Responding to Weaknesses in Quality Control
 - (i) Review of Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance

The objective of the inspection procedures in this area was to continue to identify and assess the monitoring processes that the Firm considers to be significant to its ability to monitor audit quality for individual engagements and for the Firm as a whole. Toward that objective, the inspection team interviewed members of the Firm's management and reviewed certain documents to build on its understanding of how the Firm identifies, evaluates, and responds to possible indicators of deficiencies in audit performance, including internal inspection findings, PCAOB inspection observations, restatements, and litigation. In addition, the inspection team reviewed documents related to the design, operation, and evaluation of findings of the Firm's internal inspection program. The inspection team also reviewed certain audits that the Firm had inspected and compared the results to those of the Firm.

(ii) Review of Response to Weaknesses in Quality Control

The objectives of the inspection procedures in this area were to assess the design and test the effectiveness of the Firm's processes for addressing possible deficiencies in the Firm's system of quality control, including any deficiencies in the Firm's system of quality control that were noted in prior PCAOB inspection reports. Toward those objectives, the inspection team reviewed steps the Firm has taken in the past several years to address possible quality control deficiencies. The inspection team then assessed the design and evaluated the effectiveness of the processes identified. In addition, the inspection team conducted focused inspections of audits of certain issuers whose audits had been reviewed during previous PCAOB inspections of the Firm to ascertain whether the audit procedures in areas with previous deficiencies had been improved.

(iii) Review of Certain Other Policies and Procedures Related to Monitoring Audit Quality

In this area, the procedures included obtaining an update of the inspection team's understanding of policies, procedures, and guidance related aspects of to the Firm's independence requirements and its consultation processes and the Firm's compliance with them. In addition, the inspection team reviewed documents, including certain newly issued policies and procedures, and interviewed Firm management to update its understanding of the Firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

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.^{10/}

^{10/} In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.



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May 25, 2010

Response to Part I of the Draft Report on the 2009 Inspection of Ernst & Young LLP

Dear Mr. Diacont:

We are pleased to provide our response to the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") regarding Part I of the Draft Report on the 2009 Inspection of Ernst & Young LLP (the "Report"). We believe the inspection process is a fundamental component of the PCAOB's mission.

Our overriding objective is to make certain that all aspects of our auditing and quality control processes are of high quality and continue to benefit the capital markets in which the public participates. The PCAOB's inspections assist us in identifying areas where we can continue to improve our performance.

We respect the PCAOB's inspection process and understand that judgments are involved both in the performance of an audit and in its subsequent inspection. Recognizing the constructive intent of the inspection process, we made every effort to cooperate with the PCAOB staff. We have thoroughly evaluated the matters described in Part I - *Inspection Procedures and Certain Observations* of the Report and have taken actions, where appropriate, in accordance with EY's policies and PCAOB standards.

We appreciate the opportunity to provide our response to the Report and look forward to continuing to work with the PCAOB on matters of interest to our public company auditing practice.

Respectfully submitted,

A handwritten signature in cursive script that reads 'Ernst & Young LLP'.

Copy to: Mr. Daniel L. Goelzer
Mr. Bill Gradison
Mr. Steven B. Harris
Mr. Charles D. Niemeier