

Report on

**2010 Inspection of KPMG LLP
(Headquartered in New York, New York)**

Issued by the

Public Company Accounting Oversight Board

November 8, 2011

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

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SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

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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 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 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 financial statement misstatements, including failures to comply with 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 apparent misstatements 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 whether an issuer's financial statements are misstated or fail to comply with Commission disclosure requirements, rests with the Commission. Any description, in this report, of financial statement misstatements or failures to comply with 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.



2010 INSPECTION OF KPMG LLP

Preface

In 2010, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm KPMG LLP ("KPMG" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report, Appendix C, and portions of Appendix D.^{1/} Appendix C provides an overview of the inspection process for annually inspected firms.^{2/} Appendix D includes the Firm's comments, if any, on a draft of the report.^{3/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system) is nonpublic, unless the firm fails to make sufficient progress in addressing those criticisms.

^{1/} In its Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004), the Board described its approach to making inspection-related information publicly available consistent with legal restrictions.

^{2/} The Act requires the Board to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers.

^{3/} 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.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm performs audit work.^{4/} To achieve that goal, Board inspections include reviews of certain aspects of selected audit work performed by the firm and reviews of certain aspects of the firm's quality control system. It is not the purpose of an inspection, however, to review all of a firm's audit work or to identify every respect in which reviewed work is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audit work, or the relevant issuers' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

If the Board inspection team identifies deficiencies that exceed a certain significance threshold in the audit work it reviews, those deficiencies are summarized in the public portion of the Board's inspection report.^{5/} The Board cautions, however, against extrapolating from the results presented in the public portion of the report to broader conclusions about the frequency of deficiencies throughout the Firm's practice. Audit work is selected for inspection largely on the basis of an analysis of factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

^{4/} 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.

^{5/} Inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. 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. 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. The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements. Failure by a firm to take appropriate actions, or a firm's misrepresentations, in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures for the inspection from September 2009 through February 2011. The inspection team performed field work at the Firm's National Office and at 33 of its approximately 87 U.S. practice offices.

A. Review of Audit Engagements

The 2010 inspection of the Firm included reviews of aspects of 52 audits performed by the Firm and reviews of the Firm's audit work on two other issuer audit engagements in which the Firm played a role but was not the principal auditor. The inspection team selected the audits and aspects to review, and the Firm was not allowed an opportunity to limit or influence the selections.

The inspection team identified matters that it considered to be deficiencies in the performance of the audit work it reviewed. Those deficiencies included failures by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,^{6/} as well as failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures. In some instances, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices. In some cases, the conclusion that the Firm failed to perform a procedure was based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claimed to have performed the procedure.^{7/}

^{6/} 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 applicable accounting principles, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

^{7/} PCAOB Auditing Standard No. 3, *Audit Documentation*, 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.

One of the deficiencies described below relates to auditing an aspect of an issuer's financial statements to which the issuer made substantial adjustments after the primary inspection procedures.^{8/}

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR"). In addition, one of the identified deficiencies, which occurred in an audit in which the Firm played a role but was not the principal auditor, was of such significance that it appeared to the inspection team that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audit. The audit deficiencies that reached these levels of significance are described below.^{9/}

1. Deficiencies in Testing the Fair Value Measurements and Disclosures of Financial Instruments Without Readily Determinable Fair Values

In seven audits,^{10/} due to deficiencies in testing the fair value measurements of, and the disclosures related to, financial instruments without readily determinable fair values ("hard-to-value financial instruments"), including private debt securities, collateralized mortgage obligations, and other mortgage-backed securities, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions. The deficiencies related to Issuers F and G are described separately below. The deficiencies in the other five audits^{11/} are as follows –

^{8/} The Board inspection process did not include review of any additional audit work related to the restatements and adjustments.

^{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.

^{10/} Issuers A, B, C, D, E, F, and G

^{11/} Issuers A, B, C, D, and E

- In each of the five audits, the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying certain fair value measurements that were obtained from pricing services or other third parties and used in the Firm's testing of the fair value of the hard-to-value financial instruments.
- The Firm failed to evaluate the implications of significant differences in fair value measurements from different sources for individual financial instruments, as follows:
 - In three of these audits,^{12/} for certain financial instruments, the Firm obtained multiple prices and used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.
 - In one of these audits,^{13/} the Firm established thresholds to identify pricing differences for further testing; however, the Firm set the thresholds at a level that caused the Firm not to identify significant differences in prices for individual financial instruments.
- There were additional deficiencies related to the Firm's testing of fair value of hard-to-value financial instruments in three of the five audits:
 - In one of these audits,^{14/} the Firm failed to test the fair value of certain financial instruments for which it had requested, but not received, a price from its pricing services.
 - In another of these audits,^{15/} for financial instruments valued and tested using the issuer's third-party valuation specialists, there was no evidence

^{12/} Issuers A, C, and D

^{13/} Issuer B

^{14/} Issuer B

^{15/} Issuer C

in the audit documentation (other than a general statement that procedures had been performed), and no persuasive other evidence, that the Firm had tested the data used by these specialists to determine if the data were accurate, complete, and relevant. In addition, in this audit, the Firm failed to test the accuracy of any of the calculations included in the specialists' reports.

- In another of these audits,^{16/} the Firm failed to perform sufficient tests of controls over the valuation of certain available-for-sale ("AFS") securities to support its opinion on the effectiveness of ICFR. The Firm relied on one control over the valuation of these AFS securities: a review of individual securities with a change in fair value from the prior month in excess of an established threshold. The Firm's testing of this control was insufficient since it failed to test whether variances in excess of the threshold had been appropriately investigated, including whether the issuer's explanations were supported.
- In all five audits, the Firm failed to adequately test the issuer's disclosures of certain hard-to-value financial instruments as level 2 or level 3 because it failed to obtain an understanding of whether significant inputs used to value the financial instruments were observable or unobservable.

2. Issuer F

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The Firm's failures related to control and substantive testing with respect to the valuation of the issuer's financial instruments.

The issuer's traders determined the fair value of financial instruments. On at least a monthly basis, issuer personnel other than the traders ("price verifiers") performed procedures ("price verification procedures") to determine whether the traders' fair values were reasonable. The price verifiers and the price verification procedures differed depending on the type of financial instrument and its classification within the fair value hierarchy. The price verification procedures for financial instruments classified as Level 1 and Level 2 included (1) an automated comparison of the trader's fair value to

^{16/} Issuer A

prices for the same or similar instruments provided by pricing services or other third parties, (2) comparing the inputs that the traders had used in issuer-approved models to value certain Level 2 financial instruments (“model-valued financial instruments”) to available market data, or (3) comparing the trader’s fair value to the fair value the price verifier had developed. The issuer classified financial instruments that had little or no market transparency and for which the aforementioned procedures could not be performed as Level 3. For certain Level 3 financial instruments, the price verifiers were required to perform some analysis to determine whether the fair value was within a reasonable range or document why such analysis was not possible. The issuer’s control procedures required a third group to investigate and resolve differences between the price verifier’s and the trader’s prices that were in excess of established thresholds. For control and substantive testing, the Firm selected the issuer’s portfolios that it considered to be significant.

For control testing, the Firm concluded that the issuer’s price verification procedures over all the diverse financial instruments in the portfolios constituted a single control that operated monthly with a “risk of failure of lower.” The Firm’s conclusion was inappropriate as the Firm did not take into account (1) the different price verification procedures the issuer performed, which ranged from straightforward automated procedures for Level 1 instruments to highly complex judgmental procedures for Level 3 instruments, and (2) the different inherent risks and the fraud risk associated with the various financial instruments, especially the hard-to-value Level 2 and Level 3 instruments. As a result of the Firm’s inappropriate conclusion, the Firm’s sample sizes (generally zero, one, or two) for control testing of the price verification procedures for Level 3 financial instruments were inadequate.

The Firm’s control testing of the price verification procedures for certain Level 3 financial instruments also was insufficient as the Firm failed to test whether variances between the price verifier’s and the trader’s prices that were in excess of established thresholds were identified for investigation and appropriately resolved.

Further, for some Level 3 financial instruments, the Firm concluded that it did not need to change the nature, timing, and extent of its procedures, notwithstanding certain issues that came to the Firm’s attention regarding controls related to the valuation of these instruments.

For certain model-valued financial instruments, the Firm’s testing of the issuer’s controls to assess whether the appropriate approved models and inputs were used was insufficient to support the Firm’s conclusion that such controls were operating effectively

as the Firm:

- Failed to identify and test certain important controls within the process,
- Failed to evaluate the implications of the Firm's identification of financial instruments that had been valued using models that the issuer had not approved for those specific financial instruments,
- Inappropriately selected only one item ("a test-of-one") to test the operating effectiveness of certain application controls that addressed multiple types of financial instruments, and therefore included multiple models and multiple pricing inputs, and
- Inappropriately used a test-of-one approach for certain controls that the Firm concluded were automated even though the issuer manually selected the models and inputs for these controls.

In addition, the controls that the Firm tested were not of sufficient precision to address the risks associated with limitations that were identified in the issuer's use of certain models to value certain significant portfolios.

The Firm's substantive testing related to significant Level 3 portfolios also was insufficient because testing only one financial instrument for certain portfolios was inappropriate given the level of risk of material misstatement associated with such portfolios.

In addition, for certain hard-to-value Level 2 financial instruments, the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying the fair value estimates that were obtained from pricing services or other third parties and used in the Firm's testing related to these financial instruments. Further, the Firm used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.

3. Issuer G

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The

Firm's failures related to control testing with respect to the issuer's AFS securities and the control and substantive testing with respect to the issuer's allowance for loan losses ("ALL").

Available-for-Sale Securities

The Firm failed to perform sufficient tests of controls with respect to a significant portfolio of the issuer's AFS securities to support its opinion on the effectiveness of ICFR. A majority of these securities were valued by the issuer using information from pricing services. The control that the Firm tested over the valuation of these AFS securities was a review of individual securities with a change in fair value from the prior month in excess of an established threshold. The Firm, however, failed to test the completeness and accuracy of information in the variance reports used by management in performing the control and failed to assess whether variances in excess of the threshold had been appropriately investigated, including whether the issuer's explanations were supported.

Allowance for Loan Losses

With respect to the model-based reserves for consumer loans, the Firm failed to perform sufficient tests of controls and/or substantive tests related to the issuer's segmentation of loans, the appropriateness of the issuer's models, the assumptions the issuer input into the models, and the issuer's adjustments to the model-based reserves.

Segmenting loans was a significant procedure that the issuer performed in determining the model-based reserves. The Firm, however, failed to test controls over and perform substantive tests of certain data attributes that the issuer used to segment consumer loans, including data attributes that may have changed since the origination of the loans.

The Firm's tests of controls to address the reasonableness of certain significant assumptions that the issuer input into the models and the reasonableness of the issuer's adjustments to the model-based reserves, and to assess whether the models used to calculate the ALL were the same as those that had been approved, were limited to tests of review controls. The Firm's testing of certain of these review controls, however, was insufficient as it consisted only of determining whether the appropriate personnel had performed the review and did not test the effectiveness of the review. Specifically, in many instances, the Firm failed to understand and test the criteria the issuer used to identify unusual items for investigation. In addition, in some instances,

the Firm failed to test whether the issuer appropriately investigated and supported or adjusted items that met the issuer's criteria.

The Firm also failed to perform sufficient substantive tests of (1) certain microeconomic assumptions that the issuer had input into the models, (2) the issuer's weighting of the model-based results, and (3) a manual adjustment to the consumer ALL that the issuer recorded at year end. The Firm's testing of the microeconomic assumptions was insufficient because it failed to test that the assumptions that were input into the models were the same as those that had been approved, since the Firm's testing consisted solely of inquiry of the issuer and noting that the model-based results for the more pessimistic assumptions resulted in higher loss estimates than the ones for more optimistic assumptions. The Firm's testing of the weighting of the model-based results, for which the Firm had identified a fraud risk, consisted of reviewing the issuer's analysis of the model-based loss forecasts compared to the actual incurred losses ("backtesting analyses") and analytical procedures. In some cases, the Firm failed to test the completeness and accuracy of the data underlying the issuer's backtesting analyses and investigate the implications of significant differences between the model-based loss forecasts and the actual incurred losses. Also, the Firm's analytical procedures were not sufficiently precise to provide the necessary level of assurance since they were not performed at a disaggregated level. With respect to the manual adjustment, the Firm obtained the issuer's calculations before and after the adjustment, understood the changes in the assumptions between the two, and performed trend analyses that were not designed to provide the necessary level of assurance for identifying potential material misstatements. In addition, the Firm selected only one of the many loan portfolios for detailed testing and, in this instance, failed to identify that one of the assumptions it tested was inconsistent with a similar assumption that a Firm specialist had tested and that the Firm had used in its other tests of this portfolio.

With respect to the issuer's ALL for commercial loans, the Firm failed to evaluate whether the issuer sufficiently addressed the relevant environmental factors, including industry, geographical, economic, and political factors, identified in SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues* ("SAB 102"). In addition, the Firm performed analytical procedures to address observations that it and its specialists had regarding the issuer's methodology for developing the commercial ALL. These analytical procedures, however, did not incorporate recent upward trends in actual losses, included adjustments to historical data that had not been tested, and reflected assumptions that were inconsistent with the assumptions used in other analytical procedures related to the ALL.

4. Issuer H

In this audit, the Firm failed to perform sufficient audit procedures with respect to a goodwill balance recorded in the prior year that was impaired in the current year. The issuer reorganized its reporting units in the first quarter of its prior fiscal year and reassigned goodwill to the new reporting units at the end of that year, which is contrary to generally accepted accounting principles (“GAAP”). The issuer reassigned the goodwill based on relative fair values that it computed using discounted cash flow (“DCF”) models. In that year’s audit, the Firm failed to address that the DCF models did not include terminal values, used discount rates that were not developed based on observable inputs, and were based on cash flow assumptions as of the end of that year, rather than as of the time of the reorganization.

During the current year, the Firm documented its assessment of the reasonableness of the issuer’s reassignment of goodwill, and identified the issuer’s failure to include terminal values in the DCF models. The Firm then developed an independent expectation of the fair value of each reporting unit. The Firm’s fair value estimates were inappropriate as:

- The fair value estimates for two of the reporting units were based on the issuer’s cash flow projections as of the prior year end rather than as of the date of the reorganization. In addition, the Firm had no support for the terminal values that it used in these estimates.
- The third reporting unit had two components. The Firm estimated that one of these components was worthless, even though the Firm did not have evidence to outweigh the objective indicators in the work papers that the component had significant value. Further, the Firm made an incorrect adjustment in estimating the fair value of the other component.
- For the fourth reporting unit, the Firm inappropriately applied a control premium to assumed debt.

5. Issuer E

In this audit, in addition to the deficiencies described in Part I.A.1 related to testing the fair value measurements of, and disclosures related to, hard-to-value financial instruments, the Firm failed in the following respects to obtain sufficient

appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR –

Allowance for Loan Losses

The Firm failed to perform sufficient tests with respect to the issuer's ALL. The issuer's residential loan portfolio included loans from multiple states and consisted mainly of adjustable-rate mortgages with interest-only features. The issuer segregated the majority of this portfolio into pools based on delinquency and further segregated non-delinquent loans into two pools based on geography. The issuer and the Firm relied on loan delinquency data provided by 13 service organizations. To calculate the ALL for this portfolio, the issuer applied a different loss reserve percentage to each of the two pools for the non-delinquent loans and different percentages to the delinquent loan pools based on the aging of the loans. The Firm did not evaluate whether it was appropriate for the issuer to –

- Apply the same loss factors to all loans in the same delinquent loan pool regardless of the state of origination, vintage, or type of loan, and
- Segregate non-delinquent loans only into two geographic locations without considering other risk characteristics.

In addition, the Firm did not evaluate whether the ALL appropriately reflected all of the significant environmental factors identified in SAB 102, such as trends in delinquencies and impaired loans, trends in charge-offs and recoveries, national and local economic trends and conditions, and effects of changes in credit concentrations.

With respect to the delinquency data, the Firm failed to obtain service auditors' reports from any of the 13 service organizations or perform other appropriate procedures to test the completeness and accuracy of the loan delinquency data. The Firm tested the issuer's control that compared delinquent loans in the most recent period to the delinquency status of such loans in the prior period to identify unexpected changes. This control, however, would not identify loans reported as non-delinquent that should have been reported as delinquent. Also, the Firm did not perform any substantive procedures to test the delinquency data provided by the service organizations.

Customer Receivables and Payables

The Firm failed to perform sufficient internal control and substantive testing with respect to customer receivables and payables. The Firm did not send confirmation requests and instead performed control and substantive testing related to the issuer's reconciliations, customer trade confirmations and statements, and the customer complaints process.

The issuer used various information technology ("IT") programs to compare data in its internal information systems to data provided by external counter-parties, and to generate exception reports and data output files used in the reconciliations. The Firm's testing of the completeness and accuracy of certain of these reports and files used in the reconciliations was insufficient. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had determined whether certain of the programs used in the reconciliation process were subject to Information Technology General Controls ("ITGCs") that the engagement team had tested. As a result, the Firm lacked a basis for applying the test-of-one approach that it used to test the completeness and accuracy of certain reports and files used in the reconciliations.

In addition, the Firm's testing of the customer trade confirmations and statements, and the customer complaints process, was insufficient as the Firm failed to

- Test whether the issuer could modify customer confirmations or statements or prevent them from being generated or sent to the customer,
- Perform sufficient testing of the completeness and accuracy of customer statements, as only one customer statement was selected for testing and not all relevant attributes and data were tested, including the name and address of the customer, and
- Test the completeness of the complaints report, or the controls over the completeness of the complaints report, which the Firm used when selecting a sample for substantive testing.

6. Issuer I

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR.

Internal Control

With respect to the opinion on the effectiveness of ICFR, the Firm failed to sufficiently test ITGCs for a significant financial application. The Firm identified that a large number of users, including programmers, had unrestricted access to the operating system and administrator access to the application, and the programmers had the ability to make changes directly to the production environment of this application. The Firm identified manual controls that it had tested that it believed mitigated these risks; however, certain of these manual controls were entity-level review controls that were not designed in a way to mitigate the user-access risks, as these controls relied on financial information from the application that was subject to the user-access risks. Further, the Firm's evaluation of these manual controls failed to appropriately address these risks because:

- The extent of the Firm's testing of these manual controls was not sufficient because the sample sizes did not take into account the user-access risks, and
- Some of these controls were performed by users who had unrestricted access to the application and the operating system, but the Firm failed to evaluate the effect of the lack of segregation of duties on these controls.

In addition, the Firm did not test whether user-access rights granted to this application were consistent with the level of access approved by management.

Further, as a result of the Firm's failure to sufficiently test ITGCs for this significant financial application, the Firm's test-of-one approach with respect to related automated application controls was insufficient to be able to conclude on the operating effectiveness of these controls. In addition, its test-of-one approach with respect to reports used in IT-dependent manual controls and in substantive testing was insufficient to determine whether the data in such reports for loans receivable, interest income, and loan delinquencies were complete and accurate.

Allowance for Loan Losses

The issuer's ALL was calculated using percentages that had been unchanged for at least the previous five years. The issuer asserted that these percentages included the relevant environmental factors in SAB 102 (the "qualitative component"). The use of static percentages resulted in the qualitative component decreasing in periods in which the issuer experienced deteriorating loan performance and increasing in periods in which the issuer experienced improving loan performance. In the current year, there were improvements in both the issuer's loan performance and certain relevant environmental factors compared to the prior year. The use of static percentages to calculate the ALL resulted in the year-end qualitative component becoming a higher percentage of the ALL than in prior periods. The Firm, however, failed to assess the reasonableness of this relationship and how these long-standing reserve percentages incorporated the relevant environmental factors within SAB 102.

In addition, the Firm also failed to sufficiently test an ALL review control. The control focused on senior management's review of the adequacy of the ALL by analyzing and comparing current and historical metrics and identifying unusual trends for investigation. The Firm, however, failed to understand and evaluate the criteria used by the issuer to identify unusual trends for investigation. One metric that management analyzed related to trends in charge-offs; however, the Firm failed to sufficiently test controls related to the timing of charge-offs. The issuer's policy was to charge off loans at the earlier of when such loans were deemed to be uncollectible or when a certain period had elapsed since the date of the last full payment. The Firm's control testing did not address whether loans that became uncollectible before the predetermined period of time were appropriately deemed to be uncollectible and were charged off on a timely basis.

Loans Receivable

Based on the premise that its degree of reliance on the controls described above was warranted, the Firm used negative confirmations to obtain its primary audit evidence concerning the existence of loans receivable. As described above, however, the Firm's control testing was insufficient to support its reliance on controls, and, as a consequence, the use of negative confirmation requests was insufficient to evaluate the existence of loans receivable.

In addition, the issuer concluded that none of its loan renewals constituted troubled debt restructurings; however, this conclusion was based on a specific policy, the application of which the Firm failed to test.

7. Issuer J

In this audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The majority of the issuer's revenue was earned from the sale and installation of products under customer contracts. The issuer disclosed that it could not reliably estimate total contract costs; nonetheless, the issuer recorded contract revenue using the percentage-of-completion method of accounting, which is inappropriate when contract costs cannot reliably be estimated.

8. Issuer K

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinion on the effectiveness of ICFR. Specifically, the Firm failed to test controls over the completeness and accuracy of data migrated from the issuer's primary database to a secondary database that was used to generate financial reports, including the issuer's financial statements.

9. Issuer L

In this audit, the Firm audited the financial statements of a subsidiary based on instructions from a foreign affiliated firm. The operations of this subsidiary constituted the majority of the issuer's operations. The Firm failed to perform sufficient procedures to test the recognition of deferred service revenue. Specifically, the Firm failed to evaluate the effects of the issuer recognizing deferred service revenue over a period that was inconsistent with relevant historical data. The historical data indicated that the issuer performed significant amounts of service beyond the period the issuer used for recognizing revenue.

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, APPENDIX A, AND APPENDIX B OF THIS REPORT ARE
NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX C

THE INSPECTION PROCESS FOR ANNUALLY INSPECTED FIRMS

The inspection process is designed, and inspections are performed, to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. This appendix describes the inspection process for those annually inspected firms that have multiple practice offices and a national office structure. While this appendix describes the general inspection process applied in the 2010 inspections of these firms, the process was customized to each firm's inspection, bearing in mind the firm's structure, past inspection observations, observations during the course of the 2010 inspection, and other factors. Accordingly, procedures described in this Appendix, while generally applicable to annual inspections, may not have been applied, or may not have been applied fully, in the inspection of any individual firm, and additional procedures, not described in this appendix, may have been applied in the inspection of an individual firm.

The inspection process included reviews of aspects of selected issuer audits completed by the inspected firm. These reviews were intended both to identify deficiencies, if any, in those aspects of the audits and to determine whether those deficiencies indicated weaknesses or defects in 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

Inspections include reviews of aspects of selected audits of financial statements and ICFR. For each audit selected, the inspection team reviewed certain of the issuer's SEC filings. The inspection team selected certain aspects of the audits for review and inspected the engagement team's work papers and interviewed engagement personnel regarding those aspects. 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 and, for some engagements, the inspection team 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 was allowed the opportunity to provide a written response to the comment form.

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

The inspection team's review of a firm's system of quality control was intended to provide a basis for assessing whether that system was appropriately designed and implemented to achieve the goal of conducting audits that are in compliance with applicable standards. This review included an 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

Procedures in this area were designed to focus on (a) 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) whether actions and communications by the firm's leadership – the "tone at the top" – demonstrate a commitment to audit quality. The inspection team interviewed members of the firm's leadership to obtain an understanding of any significant changes in the firm's approach to, and processes for, its management, including the mechanisms, formal or informal, that assess, monitor, or affect audit performance. The inspection team also 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

Procedures in this area were designed to focus on (a) whether 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) the firm's processes for allocating its partner resources; and (c) 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 documentation related to certain of these topics. In addition, the inspection team's interviews of audit partners included questions regarding their responsibilities and allocation of time and the interviews of firm management

included the performance of partners being inspected, the evaluation and compensation process, any disciplinary actions, and any situations where a client requested a change in the lead audit partner. 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 inspection team 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 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. In some cases, 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

Procedures in this area were designed to identify and assess the monitoring processes that the firm uses to monitor audit quality for individual engagements and for the firm as a whole. The inspection team interviewed members of the firm's

management and reviewed documents regarding 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 its results to those from the internal inspection.

(ii) Review of Response to Weaknesses in Quality Control

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

The inspection team assessed policies, procedures, and guidance related to aspects of 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 consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

APPENDIX D

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.^{17/}

^{17/} 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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October 14, 2011

Ms. Helen A. Munter
Director, Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: Response to Part I of Public Company Accounting Oversight Board (PCAOB) Draft Report on
2010 Inspection of KPMG LLP

Dear Ms. Munter:

We appreciate the opportunity to read and comment on Part I of the PCAOB's Draft Report on the 2010 Inspection of KPMG LLP dated September 15, 2011 ("Draft Report"). We share a common objective – serving our capital markets by performing high quality audits – and the PCAOB's inspection process serves to assist us in identifying areas where we can continue to improve our performance and strengthen our system of audit quality control. We also would like to acknowledge the professionalism and commitment of the PCAOB staff and the important role the PCAOB plays in improving audit quality.

We conducted a thorough evaluation of the matters identified in the Draft Report and addressed the engagement-specific findings in a manner consistent with PCAOB auditing standards and KPMG policies and procedures.

We remain dedicated to evaluating our system of quality control, monitoring audit quality and implementing changes to our policies and practices in order to enhance audit quality. We are mindful of our responsibility to the capital markets and are committed to continually improving our firm and the profession and working constructively with the PCAOB to improve audit quality.

Very truly yours,

KPMG LLP

cc: Mr. James R. Doty
Mr. Lewis H. Ferguson
Mr. Daniel L. Goelzer
Mr. Jay D. Hanson
Mr. Steven B. Harris