

**Report on**  
**2015 Inspection of Ernst & Young LLP**  
**(Headquartered in New York, New York)**

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

**October 25, 2016**

**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**

## **2015 INSPECTION OF ERNST & YOUNG LLP**

### Preface

In 2015, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.D of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included reviews of portions of selected issuer audits. These reviews were intended to identify whether deficiencies existed in the reviewed work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

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, portions of Appendix B, Appendix C, and Appendix D. Appendix B consists of the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the Firm's system of quality control, those discussions also could eventually be made public, but only to the extent the Firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report. Appendix C presents the text of the paragraphs of the auditing standards that are referenced in Part I.A in relation to the description of auditing deficiencies there.

*Note on this report's citations to auditing standards:* On March 31, 2015, the PCAOB adopted a reorganization of its auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015). The reorganization will be effective as of December 31, 2016, but the reorganized numbering system may be used before that date. In this report, citations to PCAOB auditing standards use the numbering system and titles of standards that were in effect at the time of the primary inspection procedures. A table cross-referencing the section numbers of those standards included in Part I of this report as reorganized is included at Appendix D.

## **PART I**

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

Members of the Board's staff ("the inspection team") conducted primary procedures<sup>1</sup> for the inspection from November 2014 to June 2016. The inspection team performed field work at the Firm's National Office and at 33 of its approximately 70 U.S. practice offices.

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

The inspection procedures included reviews of portions of 55 issuer audits performed by the Firm. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix C to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in the references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

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<sup>1</sup> For this purpose, the time span for "primary procedures" includes field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. The time span does not include (1) inspection planning, which may commence months before the primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which generally extend beyond the primary procedures.

Certain of 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 appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework and/or its opinion about whether the issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR.

The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.<sup>2</sup>

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<sup>2</sup> Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Depending upon the circumstances, compliance with PCAOB 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 its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. 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.

The audit deficiencies that reached this level of significance are described in Part I.A.1 through I.A.16, below.

*Effects on Audit Opinions*

Of the 16 issuer audits that appear in Part I.A, deficiencies in 14 audits relate to testing controls for purposes of the ICFR opinion, and deficiencies in 14 audits relate to the substantive testing performed for purposes of the opinion on the financial statements, as noted in the table below. Of the 14 audits in which substantive testing deficiencies were identified, three audits included deficiencies in substantive testing that the inspection team determined were caused by a reliance on controls that was excessive in light of deficiencies in the testing of controls.

	<b>Number of Audits</b>
Deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	12
Deficiencies included in Part I.A related to the financial statement audit only	2
Deficiencies included in Part I.A related to the ICFR audit only	2
Total	16

*Most Frequently Identified Audit Deficiencies*

The following table lists, in summary form, the types of deficiencies that are included most frequently in Part I.A of this report. A general description of each type is provided in the table; the description of each deficiency in Part I.A contains more specific information about the individual deficiency. The table includes only the three most frequently identified deficiencies that are in Part I.A of this report and is not a summary of all deficiencies in Part I.A.

Issue	Part I.A Audits
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	<u>10 Audits:</u> Issuers A, B, C, D, E, F, I, J, L, and O
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	<u>8 Audits</u> Issuers A, B, D, E, I, J, L, and N
Failure to identify and test any controls that addressed the risks related to a particular account or assertion.	<u>7 Audits:</u> Issuers A, B, C, D, E, G, and P

*Audit Deficiencies*

A.1. Issuer A

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

- The issuer generated revenue at numerous locations, where certain types of routine transactions were initiated and processed. The revenue processes were highly automated with revenue transactions being initiated, processed, and recorded by a number of different information-technology ("IT") systems. The Firm's procedures to test certain controls over revenue and accounts receivable were insufficient. Specifically –
  - In planning and performing its tests of controls at four of the issuer's components, the Firm reduced the number of locations that it selected for testing based on (1) its assumption, for each component, that the flows of transactions, IT systems, and internal controls were uniform across all locations within the component and (2) its conclusion that certain entity-level monitoring controls were effective. This reduction in the scope of the Firm's testing was not supported, as follows –

- The Firm failed to gain a sufficient understanding of the flow of transactions and controls in order to determine the scope of its testing. Specifically, the Firm based its determination on walkthroughs that were performed at certain locations, but the locations were selected without taking into account the different IT systems that were used across the various locations. (AS No. 5, paragraphs 34 and B10)
- The Firm's procedures to test the entity-level monitoring controls were insufficient. Specifically, the Firm's testing was limited to inquiring of management, gathering reports used in the operation of the controls, comparing information between these reports and also from these reports to the income statement, and inspecting emails that indicated certain reviews had occurred. The Firm failed to evaluate the criteria used by the control owners to identify matters for investigation and whether items identified for investigation were appropriately addressed. In addition, the Firm failed to gain a sufficient understanding of the issuer's budgeting process to assess whether the process would result in a budget that would be a reasonable basis for comparison to the issuer's operations. (AS No. 5, paragraphs 34, 42, and 44)
- The Firm failed to perform sufficient testing of the information-technology general controls ("ITGCs") over the IT systems that initiated, processed, and recorded revenue transactions for these four components. Specifically –
  - For three of the four components selected for testing noted above, the Firm failed to identify and test any ITGCs over certain of these IT systems or to test alternative controls that would provide assurance about the accuracy and completeness of data and reports generated by these systems. (AS No. 5, paragraph 39)
  - The Firm failed to identify and test any ITGCs, or test alternative controls, over the issuer's IT system that



supported the financial statement consolidation process; information from this system was used by the issuer in the performance of the controls described above. (AS No. 5, paragraph 39)

- At one of the four components, the issuer used multiple instances of two IT systems; each instance represented a separate occurrence of the system that could be configured differently. The Firm limited its testing of ITGCs over these systems to one instance of each system; this limitation was inappropriate absent evidence that the controls over the various instances of the systems were uniform. (AS No. 5, paragraphs 42 and 44)
- The Firm failed to sufficiently test user-access controls for certain of these IT systems at two of the four components noted above. Specifically, the Firm selected a control over the (1) granting, (2) termination, and (3) periodic review of user access to the systems that were within the scope of the Firm's testing. For certain of these systems, however, the Firm failed to test one or more of the three aspects of this control. (AS No. 5, paragraphs 42 and 44)
- The Firm used the work of the issuer's internal audit ("IA") group to test certain ITGCs at the four components, as well as at other components of the issuer. IA identified deficiencies in ITGCs at certain of the issuer's locations, but the Firm failed to evaluate the severity of these deficiencies. (AS No. 5, paragraph 62)
- At two of the four components, the Firm failed to sufficiently test certain transaction-level controls that it selected for testing. Specifically –
  - For one of these components, the Firm selected a control that consisted of the approval of both standard and customized billing rates and the review of these rates in the issuer's accounting system. The Firm, however, failed to



test the aspects of this control that related to standard billing rates, as it limited its testing to customized billing rates. (AS No. 5, paragraphs 42 and 44)

- For each of the two components, the Firm failed to identify and test any controls over the accuracy and completeness of reports that the issuer used in the performance of a revenue control that the Firm tested. (AS No. 5, paragraph 39)
- The Firm's substantive testing of revenue and accounts receivable was insufficient as follows –
  - Based on the Firm's reliance on entity-level controls, which was not supported due to the deficiencies noted above, the Firm limited its procedures at the locations that it did not select for testing to analytical procedures; these locations represented a significant portion of revenue and accounts receivable and presented a reasonable possibility of material misstatement. The analytical procedures, however, provided little to no substantive assurance. The Firm compared certain current-year data to the corresponding data for prior periods, but it failed to obtain corroboration of management's explanations for certain differences that the Firm identified for investigation. In addition, the Firm used a threshold for investigation of differences that could have resulted in a combination of undetected misstatements that aggregated to an unacceptable amount. (AS No. 9, paragraphs 11 and 12; AU 329, paragraphs .20 and .21)
  - The Firm also performed analytical procedures that it intended to be its primary substantive testing of cut-off for most of the revenue at the four components. These procedures, however, did not provide sufficient assurance, as the Firm failed to obtain corroboration of management's explanations for fluctuations that the Firm identified through these procedures. (AU 329, paragraph .21)
  - At certain of the locations selected for testing, the Firm confirmed accounts receivable at an interim date and performed procedures

to extend its conclusions on the existence of accounts receivable for the three-month period between its interim testing and the year end. The Firm's procedures to extend its conclusions were insufficient, as the procedures were limited to a comparison of the year-end accounts receivable total balance, as well as the balance in each aging category, to the balances at the interim date and at the prior year end. The Firm failed to obtain corroboration of management's explanations for certain differences that the Firm identified. In addition, for certain of the comparisons, the Firm used a threshold for investigation of differences that could have resulted in a combination of undetected misstatements that aggregated to an unacceptable amount. Further, the Firm compared certain accounts receivable ratios calculated based on the year-end balances to those as of the interim date and as of the prior year end, but, for this procedure, the Firm failed to establish a threshold for investigation of differences. (AS No. 13, paragraph 45; AU 329, paragraphs .05, .20, and .21)

- During the year, the issuer acquired two businesses. The Firm failed to perform sufficient procedures related to the valuation of certain intangible assets acquired and liabilities assumed in those transactions. Specifically
  - 
  - The Firm failed to identify and test any controls over the reasonableness of the issuer-prepared forecasts that were used in the valuation of the acquired intangible assets and assumed liabilities. (AS No. 5, paragraph 39)
  - The issuer valued the acquired intangible assets and assumed liabilities based on forecasted cash flows that were specific to the individual assets and liabilities. The Firm's procedures to test these forecasts were limited to inquiring of management, reading valuation reports prepared by the issuer's specialists, reading the preliminary purchase price allocations, and testing the mathematical accuracy of certain schedules. For one of the acquired businesses, the Firm also compared certain assumptions underlying forecasts for the acquired business as a whole to historical rates for the acquired business or the issuer, but the Firm

failed to test the assumptions underlying the specific forecasts used to value the individual assets and liabilities. For the other acquired business, the issuer used 10 years of cash-flow forecasts to value the acquired intangible assets, but the Firm's procedures to evaluate the assumptions underlying the forecasted cash flows for any of the periods beyond the first three years were limited to inquiry. (AU 328, paragraphs .26 and .28)

- The Firm selected for testing two controls that consisted of the review of impairment indicators and the review of the issuer's analysis of the possible impairment of goodwill and other intangible assets; the Firm, however, failed to sufficiently test these controls. Specifically, the Firm limited its procedures to inquiring of management, attending certain meetings that constituted part of the operation of one of these controls, inspecting emails that indicated certain reviews had occurred, and comparing certain amounts to supporting documentation. The Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to evaluate the nature of the review procedures that the control owners performed, including the criteria used to identify matters for follow up and whether those matters were appropriately resolved. In addition, the Firm failed to identify and test any controls over the forecasts that the issuer used in one of these controls. (AS No. 5, paragraphs 39, 42, and 44)
- The Firm selected for testing a control that consisted of the review of the statement of cash flows; however, the Firm failed to sufficiently test this control. Specifically, the Firm's procedures were limited to inquiring of the control owners; inspecting emails, the statement of cash flows, and documents with signatures and other notations that indicated reviews or other activities that were part of the control had occurred; and testing the mathematical accuracy of certain calculations without determining whether this testing constituted a reperformance of the specific actions taken by the control owner as part of the control. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria used to identify matters for follow up and

whether those matters were appropriately resolved. (AS No. 5, paragraphs 42 and 44)

A.2. Issuer B

In this audit of a developer and manufacturer of pharmaceutical products, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR –

- The Firm failed to perform sufficient procedures related to the valuation of goodwill and intangible assets acquired as part of a business combination. Specifically –
  - The Firm selected for testing two controls that included the review of assumptions that the issuer used in the valuation of the acquired intangible assets. The Firm's procedures to test these controls were limited to inquiring of issuer personnel and inspecting emails, calendar invitations, meeting agendas, and other documents that indicated reviews and certain other actions performed as part of the controls had occurred. The Firm failed to evaluate the effectiveness of the specific review procedures that the control owners performed, the criteria used by the control owners to identify matters for follow up, and whether those matters were appropriately addressed. (AS No. 5, paragraphs 42 and 44)
  - The Firm failed to identify and test any controls over certain significant assumptions that the issuer used to allocate the goodwill resulting from the acquisition to its reporting units. (AS No. 5, paragraph 39)
  - The Firm failed to identify and test any controls, and to perform any substantive procedures, related to the issuer's determination of the estimated useful lives of the acquired intangible assets. (AS No. 5, paragraph 39; AS No. 13, paragraph 8)
  - The Firm failed to perform sufficient procedures to evaluate the reasonableness of certain assumptions that the issuer used (1) in the valuation of the acquired intangible assets and (2) to allocate

goodwill to its reporting units. Specifically, the Firm's procedures were limited to inquiring of management, reading a report prepared by the issuer's specialist, testing the mathematical accuracy of certain calculations, and comparing the assumptions to certain external analysts' projections selected by the issuer to develop the projections. The Firm concluded that these assumptions were reasonable without evaluating (1) whether these projections reflected assumptions that were relevant to the issuer's facts and circumstances or (2) the issuer's basis for selecting those specific external analysts' projections. (AU 328, paragraphs .26, .28, .31, and .36; AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures related to the sales return allowance and the chargeback accrual and related chargebacks, for which a fraud risk was identified. Specifically –
  - The Firm identified a control deficiency due to the control owner's failure to perform the aspect of a control consisting of the review of the completeness of the sales data used in the preparation and review of the monthly sales return allowance. The Firm identified two controls that it believed would compensate for this deficiency; these compensating controls consisted of (1) the review of the overall reasonableness of revenue adjustments, including the adjustments related to the sales return allowance, and (2) a comparison of amounts included within the financial statements to the budget and a review of those financial statement amounts for reasonableness. The Firm's procedures to test these controls were limited to inquiring of issuer personnel, attending certain meetings, reading certain presentations, and comparing certain balances to the budget and/or to the financial statements. The Firm failed to evaluate whether these controls operated at a level of precision that would detect potential material misstatements that could have resulted from the identified control deficiency related to the completeness of the sales data. (AS No. 5, paragraph 68)
  - In its testing of another control, which consisted of the reconciliation of the sales return allowance to the general ledger, the Firm identified an error in one of the assumptions that the issuer used to

calculate the allowance. The Firm's evaluation of the effect of this exception on its conclusion regarding the effectiveness of the control was limited to noting that the actual misstatement that occurred as a result of the exception was not material, without evaluating whether there was a reasonable possibility that the control would fail to prevent or detect a misstatement that could be material. (AS No. 5, paragraph 64)

- The issuer used inventory reports submitted by its wholesalers in the calculation and review of the chargeback accrual and related chargebacks. The Firm's procedures to test the accuracy and completeness of, and controls over the accuracy and completeness of, those reports were insufficient. Specifically, the Firm's procedures were limited to inquiring of the control owners and comparing the inventory balances reported by the issuer's three largest wholesalers to the issuer's projected inventory balances, which were also based on the inventory balances reported by those wholesalers. In addition, the Firm failed to identify and test any controls over certain manual inputs used in an automated control related to chargeback claim processing that the Firm tested. Further, the Firm failed to perform any substantive procedures to test these manual inputs, which were used to determine the chargebacks. (AS No. 5, paragraphs 39, 42, and 44; AS No. 15, paragraph 10; AU 342, paragraph .11)
- The Firm failed to perform sufficient procedures related to revenue and related accounts receivable at certain locations that, when aggregated, presented a reasonable possibility of material misstatement to the issuer's consolidated financial statements. Specifically –
  - The Firm failed to identify and test any controls over this revenue and these accounts receivable. (AS No. 5, paragraphs 39 and B10)
  - The Firm's planned approach for substantively testing this revenue and these accounts receivable consisted of the performance of analytical procedures; however, these procedures provided little to no substantive assurance. Specifically, the Firm compared certain current-year and current-quarter data to the corresponding data for



the prior year and prior quarter, but failed to perform procedures to determine whether the prior-period data could be expected to be predictive of the issuer's current-year and current-quarter data. In addition, the Firm's evaluation of the results of these procedures was limited to inquiry of management. (AU 329, paragraphs .17 and .21)

A.3. Issuer C

In this audit of an issuer that develops, manufactures, and supplies technology equipment and services, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer recognized revenue using various methods of accounting that were selected based on the nature of the underlying transaction and included: (1) the percentage-of-completion ("POC") method and (2) upon shipment of a product or completion of a service. The Firm identified fraud risks related to revenue recognition under the POC method in two of the issuer's business units and the timing of revenue recognition for another of the issuer's business units. The Firm's testing related to revenue in these three business units and one additional business unit was insufficient in the following respects –

- The issuer entered into multiple separate contracts with the same individual customers in close proximity. The Firm, however, failed to test the aspects of the issuer's controls related to the evaluation of whether certain contracts should be considered together and accounted for as part of a multiple-element arrangement for revenue recognition purposes. In addition, the Firm failed to perform any substantive procedures to evaluate whether the contracts should have been combined and accounted for as multiple-element arrangements. (AS No. 5, paragraphs 42 and 44; AS No. 14, paragraph 30)
- For two of the business units, the Firm failed to perform sufficient procedures related to revenue as follows –
  - The Firm failed to test the aspects of the issuer's controls related to evaluating individual contracts for appropriate revenue recognition, including determining whether the contracts included multiple-element arrangements. (AS No. 5, paragraphs 42 and 44)



- For one of these business units, the Firm designed its procedures to test revenue – including the thresholds used to select contracts for testing – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the thresholds that the Firm used to select contracts to test the occurrence and allocation of this revenue were too high to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37)
- In addition, for this business unit, the Firm failed to perform any substantive procedures to evaluate whether revenue related to individual contracts with multiple elements had been recognized appropriately. (AS No. 14, paragraph 30)
- For the other business unit, the Firm failed to perform sufficient procedures to evaluate the appropriateness of revenue recognition for contracts with multiple elements. Specifically, the Firm limited its testing related to contracts with multiple elements to four contracts, which represented a small percentage of the revenue for this business unit. In addition, for those four contracts, the Firm's testing was insufficient, as its procedures were limited to (1) for one contract, inquiring of issuer personnel and obtaining an understanding of the identified multiple elements and (2) for the remaining three contracts, evaluating whether each element was recorded in the appropriate period based on the delivery date or service performance date. (AS No. 13, paragraph 8)
- For the other two business units, the Firm failed to perform sufficient procedures related to revenue as follows –
  - The Firm identified and tested a control consisting of the review of individual contracts for multiple-element arrangements and appropriate revenue recognition; this control operated with respect to contracts that exceeded a monetary threshold. The Firm, however, failed to identify and test any controls related to the review of contracts that were below that threshold; the revenue recognized related to these contracts was, in the aggregate,

multiple times the Firm's established level of materiality. (AS No. 5, paragraph 39)

- In addition, for one of these business units –
  - The Firm tested a control over the issuer's evaluation of vendor-specific objective evidence ("VSOE") and best estimate of selling price ("BESP") for certain of the issuer's products; however, the Firm failed to identify and test any controls over the evaluation of VSOE and BESP for the remaining products. The revenue related to these remaining products was, in the aggregate, multiple times the Firm's established level of materiality. In addition, the Firm failed to perform sufficient substantive procedures to test the issuer's establishment of VSOE and BESP, as its procedures were limited to testing only the same products covered by the control discussed above. (AS No. 5, paragraph 39; AS No. 13, paragraph 8)
  - The Firm selected key items to test whether the revenue recognition criteria were met. For the portion of revenue that was not covered by the Firm's testing of key items, which was multiple times the Firm's established level of materiality, the Firm failed to perform sufficient procedures. Specifically, although the Firm tested revenue recognition for a sample of invoices from this portion of revenue, the Firm had selected these invoices to support its accounts receivable cut-off testing; as a result, the sample was selected from only three months during the year and therefore was not representative of the revenue population. (AS No. 13, paragraph 8; AU 350, paragraph .24)
- For the other business unit –
  - The Firm failed to test any aspects of the issuer's controls, and to perform any substantive procedures, that addressed (1) whether VSOE existed and (2) the appropriateness of the

methodology that the issuer used to establish BESP. (AS No. 5, paragraphs 42 and 44; AS No. 14, paragraph 30)

- The Firm selected key items to test whether the revenue recognition criteria were met. For the portion of revenue that was not covered by the Firm's testing of key items, which was multiple times the Firm's established level of materiality, the Firm failed to perform sufficient procedures. The Firm selected one contract from this portion of revenue to evaluate whether revenue was appropriately recognized and also tested revenue recognition for a sample of invoices. The Firm, however, had selected these invoices to support its accounts receivable cut-off testing; as a result, the sample was selected from only three months during the year and therefore was not representative of the revenue population. (AS No. 13, paragraph 8; AU 350, paragraph .24)

#### A.4. Issuer D

In this audit of an issuer in the oil and gas industry, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR –

- The Firm failed to perform sufficient procedures to evaluate the issuer's ability to continue as a going concern and the issuer's related disclosures. The issuer and the Firm identified certain adverse events and conditions that arose before, and immediately after, year end and included significant declines in oil prices and the cancellation of a long-term contract by one of the issuer's largest customers. The issuer developed a forecasted financial plan to evaluate the effect of these events and conditions. The Firm's procedures to evaluate the assumptions used to develop the forecasted financial plan consisted of inquiring of management, comparing the forecasted plan to the issuer's results for the preceding year, and performing sensitivity analyses. These procedures were insufficient because the comparison of the forecasted plan to the preceding-year results did not take into account the adverse conditions, and the sensitivity analyses, which purported to address the adverse conditions, involved

reducing revenue and expenses by roughly equal percentages, even though there was evidence that indicated that significant aspects of relevant expenses were likely fixed. (AU 341, paragraph .09)

- The Firm failed to perform sufficient procedures related to the valuation of property, plant, and equipment that the issuer held for use. Specifically –
  - The Firm selected for testing a control over the analysis of the possible impairment of this property, plant, and equipment; the control included the review of significant assumptions underlying the issuer's undiscounted cash-flow forecasts. The Firm, however, failed to sufficiently test this control. Specifically, the Firm limited its procedures to inquiring of the control owners, obtaining evidence that reviews and/or certain other actions performed as part of the control had occurred, testing the mathematical accuracy of certain calculations, and comparing certain amounts to supporting documentation. The Firm failed to test whether this control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the evaluation of the support for the assumptions, the criteria used to identify matters for follow up, and how those matters were resolved. (AS No. 5, paragraphs 42 and 44)
  - The Firm failed to sufficiently evaluate the reasonableness of the significant assumptions underlying the undiscounted cash-flow forecasts that the issuer used in evaluating this property, plant, and equipment for possible impairment. Specifically, the Firm's procedures were limited to inquiring of management, testing the mathematical accuracy of certain schedules, performing a sensitivity analysis for certain of the assumptions, and comparing the assumptions used in the cash-flow forecasts to historical industry data or the issuer's historical performance for the last five years, without considering the possible effect of the adverse events and circumstances that the issuer and the Firm identified. In addition, the Firm failed to evaluate the reasonableness of the length of the terminal period used in the forecasts for certain of the issuer's segments. (AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures related to property, plant, and equipment that was idle and not considered to be available for use in its present condition. Specifically –
  - The Firm failed to identify and test any controls over the determination of the fair value of these assets. (AS No. 5, paragraph 39)
  - The Firm failed to sufficiently test the fair value measurements used in determining the potential impairment of certain of these assets. Specifically, the Firm's procedures were limited to inquiring of management and comparing the fair value determined by the issuer, which was the same for each of the assets, to an email that the issuer had received from an external party stating that the value was appropriate. The Firm failed to obtain an understanding of and evaluate the methods and assumptions used by either the issuer or the external party. (AU 328, paragraphs .26, .28, .31, and .36)

A.5. Issuer E

In this audit of a developer and manufacturer of medical products, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to inventory. Specifically –

- The issuer's inventory was subject to cycle counts and the issuer used system-generated reports that specified which items to count each day. The Firm's procedures to test the existence of, and controls over the existence of, certain of the issuer's inventory were insufficient. Specifically, in determining that the cycle-count procedures that the issuer used for this inventory were sufficiently reliable, the Firm failed to consider the extent of the inventory items counted and the frequency of the counts. (AS No. 5, paragraphs 42 and 44; AU 331, paragraph .11)
- The Firm failed to identify and test any controls that addressed whether the types of labor and overhead costs that were included in inventory were appropriately capitalized. In addition, the Firm did not perform substantive

tests of the labor and overhead costs that were capitalized in inventory. (AS No. 5, paragraph 39; AU 342, paragraph .11)

- The Firm failed to sufficiently test a control that consisted of reviews of the allowance for excess and obsolete inventory. Specifically, the Firm's procedures were limited to inquiring of the control owners, noting that the reviews were performed on a timely basis, and gathering reports used in the operation of the control. The Firm failed to evaluate how matters were selected for follow up and whether those matters were appropriately addressed. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the reports that the issuer used in the performance of the control. (AS No. 5, paragraphs 39, 42, and 44)
- The Firm failed to evaluate the reasonableness of the significant assumptions and test the accuracy and completeness of the significant data that the issuer used in determining its allowance for excess and obsolete inventory. (AU 342, paragraph .11)

#### A.6. Issuer F

In this audit of a manufacturer, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer initiated and processed transactions related to sales and inventory at numerous locations. The Firm identified a fraud risk related to improper revenue recognition. The Firm's testing related to revenue, accounts receivable, and inventory was insufficient in the following respects –

- With respect to its testing of controls for certain of the issuer's locations, the Firm relied solely on its testing of certain entity-level controls. The total revenue, accounts receivable, and inventory at these locations were multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement. The Firm, however, failed to sufficiently test three of these entity-level controls. Specifically –
  - One of these controls consisted of a review by the board of directors of the annual operating plan that covered each location. The Firm's procedures to test this control were limited to inquiring of issuer personnel, inspecting the issuer's budgeting policy, and

inspecting minutes of meetings as evidence of review. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The other two controls consisted of reviews by location of (1) financial statement reporting packages and (2) comparisons of monthly operating results to the budget; the budget included information from the annual operating plan. The Firm's procedures to test these controls were limited to inquiring of the control owners and inspecting emails and/or documents used in the performance of the controls that included signatures or other notations. The Firm failed to evaluate whether items identified by the control owners for follow up were appropriately addressed. (AS No. 5, paragraphs 42 and 44)
- Based on the Firm's reliance on entity-level controls, which was not supported due to the deficiencies that are discussed above, the Firm limited its procedures to test revenue, accounts receivable, and inventory for the above-noted locations to performing sales cut-off procedures, inquiries, or analytical procedures, which compared current-year to prior-year amounts, for a sample of these locations. The analytical procedures that the Firm performed provided little to no substantive assurance, because the expectations that the Firm used were only directional in nature and the Firm's evaluation of the results of these procedures focused on only general explanations for the larger fluctuations that it had identified. (AS No. 9, paragraphs 11 and 12; AU 329, paragraphs .17 and .21)

#### A.7. Issuer G

In this audit of an issuer in the IT industry, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer had four types of revenue and, for three of these types of revenue, the Firm identified a fraud risk related to improper revenue recognition. The Firm failed to perform sufficient procedures related to revenue as follows –



- The Firm selected for testing a control that consisted of the review of criteria for recognizing revenue that would be applied to individual contracts; this control operated for contracts exceeding a monetary threshold. The Firm, however, failed to identify and test any controls that addressed the completeness of the population of contracts that was actually reviewed pursuant to this control. In addition, the Firm failed to identify and test any controls over the application of criteria for recognizing revenue for contracts with revenues below this threshold, which, in the aggregate, were multiple times the Firm's established level of materiality. (AS No. 5, paragraph 39)
- The Firm selected for testing a control that consisted of the review and approval of invoices. The Firm, however, failed to identify and test any controls over the accuracy and completeness of a report that the issuer used in the performance of this control for one of the issuer's types of revenue, which represented a significant portion of total revenue. In addition, the Firm used this report in its substantive testing of this type of revenue, but it failed to perform procedures to test the accuracy and completeness of the report. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)
- The Firm's substantive procedures to test revenue consisted of (1) selecting a sample of transactions for which to perform its tests of details and (2) performing analytical procedures. The Firm's procedures were insufficient as follows –
  - The Firm designed its sample sizes based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the samples that the Firm used to test the occurrence, completeness, and allocation of revenue were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)
  - The Firm performed two analytical procedures using certain aggregated revenues; one of these analytical procedures aggregated revenue for each of the issuer's top five customers and the other aggregated revenue by the issuer's two categories of

services. The issuer's four revenue types were, therefore, combined in these analytical procedures, and the expectations that the Firm developed were based only on the aggregated amounts. For two of the issuer's types of revenue, the Firm excluded from the tests of details described above revenue that was multiple times the Firm's established level of materiality and represented approximately 30 percent of the issuer's total revenue. Because the Firm developed aggregated analytical procedures, the expectations developed were not precise enough to identify misstatements that could be material in the portion of the two types of revenue excluded from the tests of details. (AU 329, paragraph .17)

A.8. Issuer H

In this audit of a manufacturer, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to the existence and completeness of inventory. Specifically –

- The issuer held inventory at numerous locations in the U.S. In planning and performing its tests of controls and substantive procedures related to the existence and completeness of this inventory, the Firm reduced the number of locations selected for testing based in part on its assumption that certain entity-level monitoring controls over this inventory were effective. This reduction in the scope of the Firm's testing was not supported, as the Firm failed to perform any procedures to test the effectiveness of these entity-level controls. (AS No. 5, paragraphs 22, 39, and B11; AS No. 9, paragraphs 11 and 12)
- The issuer also held inventory at multiple international plant locations that aggregated to approximately three times the Firm's established level of materiality; these locations had different inventory controls and/or used different IT applications from those used in the U.S. The Firm determined that these locations might be significant in the aggregate. The Firm's procedures related to this inventory were limited to testing certain entity-level controls that consisted of reviews of changes to balance sheet accounts, operational results, and certain plant-level activity to understand how the individual plants were performing. These controls did

not directly address the existence and completeness of this inventory. (AS No. 5, paragraph B10; AS No. 9, paragraphs 11 and 12)

A.9. Issuer I

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. During the year, the issuer acquired a significant business, which included multiple facilities that performed several different functions. The Firm's testing related to the issuer's accounting for the acquisition was insufficient in the following respects –

- The Firm selected for testing two controls that consisted of the review of the significant assumptions and data that the issuer used in the valuation of the assets acquired and liabilities assumed. The Firm also selected for testing a control that consisted of the review of adjustments related to the recording of the acquired assets and liabilities. The Firm's procedures to test these controls were limited to inquiring of management, obtaining evidence that the reviews and/or certain other actions performed as part of the controls had occurred, attending certain meetings that constituted part of the operation of two of these controls, testing the mathematical accuracy of certain calculations, reading the issuer's accounting memorandum for the transaction, and comparing certain amounts to supporting documentation. The Firm failed to obtain an understanding of how the control owners identified items as requiring follow up and evaluate whether those items were appropriately addressed. (AS No. 5, paragraphs 42 and 44)
- The issuer valued certain of the acquired assets based on their specific forecasted cash flows. The Firm's procedures to evaluate the reasonableness of these forecasts were limited to inquiring of management, comparing certain assumptions underlying forecasts for the acquired business as a whole to industry data and to historical rates for the acquired business, and testing the mathematical accuracy of certain calculations. The Firm failed to test the assumptions underlying the separate forecasts used to value the individual assets of the acquired business. In addition, the Firm identified that certain of the assumptions were significantly different from either the industry data or the historical rates for the acquired business that the Firm had used for comparison, but

the Firm concluded that the assumptions were reasonable without obtaining additional evidence. (AS No. 14, paragraph 3; AU 328, paragraphs .26, .28, .31, and .36)

- The Firm failed to sufficiently test the value of another acquired asset, as its procedures were limited to inquiring of management and reading a report prepared by the issuer's specialist. (AU 328, paragraphs .26 and .28)

#### A.10. Issuer J

In this audit of an issuer that sells technology devices and related services, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. During the year, the issuer acquired a business, but the Firm failed to perform sufficient procedures related to the valuation of the acquired intangible assets. Specifically –

- The Firm selected for testing a control that included reviews of the significant assumptions, including internally developed forecasts, that the issuer used in the valuation of these intangible assets; the Firm, however, failed to sufficiently test this aspect of the control. Specifically, the Firm limited its procedures to inquiring of the control owners, reading emails indicating that certain reviews and/or certain other actions performed as part of the control had occurred, and attending meetings that constituted part of the operation of this control. The Firm failed to evaluate the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately addressed. (AS No. 5, paragraphs 42 and 44)
- The Firm failed to perform sufficient substantive procedures to evaluate the reasonableness of the internally developed forecasts that the issuer used in the valuation of these intangible assets. Specifically, the Firm's procedures to test these forecasts consisted of inquiring of management, testing the mathematical accuracy of certain schedules, comparing previous versions of certain forecasts to those used in the valuation, and comparing the forecasts to the issuer's historical results for the last seven years for all revenue types. In evaluating the reasonableness of these forecasts, the Firm failed to consider that the issuer's revenue included the

sale of devices while the acquired business was projected to have only subscription sales. In addition, the Firm concluded that these forecasts were reasonable without evaluating whether the issuer's historical results were relevant to the acquired business that consisted of a new product that had not produced significant revenue. (AU 328, paragraphs .26, .28, .31, and .36)

A.11. Issuer K

In this audit of a retailer and wholesaler of consumer products, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as the Firm's procedures to test the existence of, and controls over the existence of, retail inventory that the issuer held at numerous locations were insufficient. In planning the audit, the Firm assumed that the two controls over the physical inventory process were designed effectively and implemented uniformly within each of the issuer's three retail divisions. These controls were over the performance of a full physical inventory count, which occurred at least once a year at each location, and the recording of adjustments to the system based on the results of those counts. The Firm selected a sample of locations for each division at which to test the operating effectiveness of these controls and perform physical inventory observations. The Firm's testing was insufficient as follows –

- For certain of the selected locations at certain divisions, the Firm's procedures to test these controls were limited to inquiry of management and inspection of documents that indicated that variances between the physical counts and the perpetual system were investigated and resolved; the Firm did not test the physical inventory count at these locations. As a result, for these divisions, the Firm's testing was insufficient to determine that the controls were applied uniformly, which was the basis for the Firm's testing approach. (AS No. 5, paragraphs 44 and B10; AU 350, paragraph .40)
- To test the existence of the retail inventory at year end, the Firm relied on its physical inventory observations, which were performed at various dates throughout the year, and also performed the following procedures: (1) testing inventory sold by reconciling sales and cost of sales to cash receipts, (2) testing controls over inventory purchases, (3) comparing inventory turnover, calculated as of year end, for the locations observed to

other locations, and (4) comparing the inventory balances at the dates when the observations were performed to the balances at each subsequent month end through the year end. The Firm's procedures were insufficient because: (1) the test of controls over inventory purchases was not designed to be a dual-purpose test and did not achieve the objective of the substantive test and (2) the Firm's procedures to identify unusual amounts in the inventory-balance comparisons were limited to inquiring about amounts that differed from the Firm's expectations; those expectations were based on seasonal trends and were only directional in nature. (AS No. 13, paragraph 8)

A.12. Issuer L

In this audit of an issuer in the financial services industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to the issuer's assessment of the possible impairment of goodwill –

- The Firm selected for testing one control that consisted of a review of the issuer's analysis of the possible impairment of goodwill; this analysis included forecasts of net income for ten years. The Firm failed to sufficiently test this control because, for the forecast periods beyond the first three years, the Firm limited its procedures to inquiring of management and inspecting certain documents prepared by management, noting evidence of review and approval. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the effectiveness of the specific steps that the control owners took to review the reasonableness of the forecasted net income for any of the periods beyond the first three years. (AS No. 5, paragraphs 42 and 44)
- The Firm's procedures to evaluate the reasonableness of the growth rate assumptions underlying the issuer's forecasts of net income beyond the first three years consisted of inquiring of management, comparing these assumptions to the issuer's historical performance, and inspecting meeting minutes prepared by the issuer that discussed certain of the growth rates. The forecasted growth rates for net income that the issuer used for the years after the first three years were significantly higher than the issuer's



recent historical averages, but the Firm concluded that these rates were reasonable without obtaining additional evidence. (AS No. 14, paragraph 3; AU 328, paragraphs .26, .28, .31, and .36)

A.13. Issuer M

In this audit of an issuer in the financial services industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as its procedures to test the valuation of securities without readily determinable fair values that the issuer classified as available-for-sale were insufficient. Specifically, the Firm's testing was limited to a small number of items and excluded over 90 percent of these securities that had a total value that was multiple times the Firm's established level of materiality. (AS No. 13, paragraph 8)

A.14. Issuer N

In this audit of an issuer in the financial services industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as it failed to perform sufficient procedures related to certain securities without readily determinable fair values –

- The only procedure that the Firm performed to test these securities was to obtain prices for the securities from the same pricing source that the issuer had used to determine the securities' valuation. The Firm failed to evaluate the appropriateness of the methods and the reasonableness of the assumptions underlying the fair value measurements that were obtained from the pricing source. (AU 328, paragraph .23)
- The Firm failed to perform sufficient procedures to test the disclosure of these securities within the fair value hierarchy as set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures*, because it failed to obtain an understanding of whether the significant inputs used to establish the fair value of these securities were observable or unobservable. (AU 328, paragraph .43)



A.15. Issuer O

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing three controls over the issuer's budget and forecasts, which were used in the issuer's assessment of the possible impairment of goodwill. The Firm, however, failed to sufficiently test these controls. The Firm's procedures were limited to inquiring of management and inspecting calendar invitations, meeting minutes, and other documents indicating that reviews and/or certain other actions performed as part of the controls had occurred. The Firm failed to test whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain and evaluate the nature of the review procedures performed by the control owners, including the criteria used to identify items for follow up and whether those items were appropriately addressed. (AS No. 5, paragraphs 42 and 44)

A.16. Issuer P

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as it failed to perform sufficient procedures to test controls over the assessment of the possible impairment of intangible assets. Specifically, the Firm failed to identify and test any controls that addressed whether impairment indicators existed. (AS No. 5, paragraph 39)

**B. Auditing Standards**

Each deficiency described in Part I.A above could relate to several provisions of the standards that govern the conduct of audits. The paragraphs of the standards that are cited for each deficiency are those that most directly relate to the deficiency. The deficiencies also may relate, however, to other paragraphs of those standards and to other auditing standards, including those concerning due professional care, responses to risk assessments, and audit evidence.

Many audit deficiencies involve a lack of due professional care. AU 230, *Due Professional Care in the Performance of Work*, paragraphs .02, .05, and .06, requires the independent auditor to plan and perform his or her work with due professional care and sets forth aspects of that requirement. AU 230, paragraphs .07 through .09, and AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 7, specify that due professional care requires the exercise of professional skepticism.

These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13, paragraphs 3, 5, and 8, requires the auditor to design and implement audit responses that address the risks of material misstatement. AS No. 15, *Audit Evidence*, paragraph 4, requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of ICFR) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

The paragraphs of the standards that are described immediately above are not cited in Part I.A, unless those paragraphs are the most directly related to the relevant deficiency.

**B.1. List of Specific Auditing Standards Referenced in Part I.A**

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited. For each auditing standard, the table also provides the number of distinct deficiencies for which the standard is cited for each of the relevant issuer audits. This information identifies only the number of times that the standard is referenced, regardless of whether the reference includes multiple paragraphs or relates to multiple financial statement accounts.

<b>PCAOB Auditing Standards</b>	<b>Audits</b>	<b>Number of Deficiencies per Audit</b>
<i>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>	A	12
	B	7
	C	5
	D	2
	E	3
	F	2

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
	G H I J K L O P	2 2 1 1 1 1 1 1
AS No. 9, <i>Audit Planning</i>	A F H	1 1 2
AS No. 13, <i>The Auditor's Responses to the Risks of Material Misstatement</i>	A B C G K M	1 1 5 1 1 1
AS No. 14, <i>Evaluating Audit Results</i>	C I L	3 1 1
AS No. 15, <i>Audit Evidence</i>	B G	1 1
AU 328, <i>Auditing Fair Value Measurements and Disclosures</i>	A B D I J L N	1 1 1 2 1 1 2

<b>PCAOB Auditing Standards</b>	<b>Audits</b>	<b>Number of Deficiencies per Audit</b>
<i>AU 329, Substantive Analytical Procedures</i>	A B F G	3 1 1 1
<i>AU 331, Inventories</i>	E	1
<i>AU 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i>	D	1
<i>AU 342, Auditing Accounting Estimates</i>	B D E	2 1 2
<i>AU 350, Audit Sampling</i>	C G K	2 1 1

**B.2. Financial Statement Accounts or Auditing Areas Related to Identified Audit Deficiencies**

The table below lists the financial statement accounts or auditing areas related to each deficiency included in Part I.A of this report and identifies the audits described in Part I.A where deficiencies relating to the respective areas were observed.<sup>3</sup> The

<sup>3</sup> Certain deficiencies that affect multiple accounts or areas, such as those related to scoping multi-location audits and those related to the evaluation of control deficiencies, are excluded from this table, but are included in Appendix C.

following standards were cited for only one issuer and are excluded from the table: AU 331 and AU 341.<sup>4</sup>

	AS No. 5	AS No. 9	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 342	AU 350
Business combinations	A, B, I, J		B	I		A, B, I, J		B	
Impairment of goodwill and intangible assets	A, L, O, P			L		L			
Inventory and related reserves	E, F, H, K	F, H	K				F	E	K
Investment securities and equity-method investments			M			N			
IT-related	A								
Long-lived assets, including amortization, depreciation, or depletion	D					D		D	
Period-end financial reporting process	A								
Revenue, including accounts receivable, deferred revenue, and allowances	A, B, C, F, G	A, F	A, C, G	C	B, G		A, B, F, G	B	C, G

<sup>4</sup> The AU 331 issue for issuer E related to inventory and the AU 341 issue for issuer D related to going concern.

B.3. Audit Deficiencies by Industry

The table below lists the industries<sup>5</sup> of the issuers for which audit deficiencies were discussed in Part I.A of this report, and cross-references the issuer to the specific auditing standards related to the deficiencies.<sup>6</sup>

	AS No. 5	AS No. 9	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 341	AU 342	AU 350
Consumer Discretionary	A, K	A	A, K			A	A				K
Energy	D, I			I		D, I			D	D	
Financial Services	L, O		M	L		L, N					
Health Care	B, E, F, P	F	B		B	B	B, F	E		B, E	
Information Technology	C, G, J		C, G	C	G	J	G				C, G
Materials	H	H									

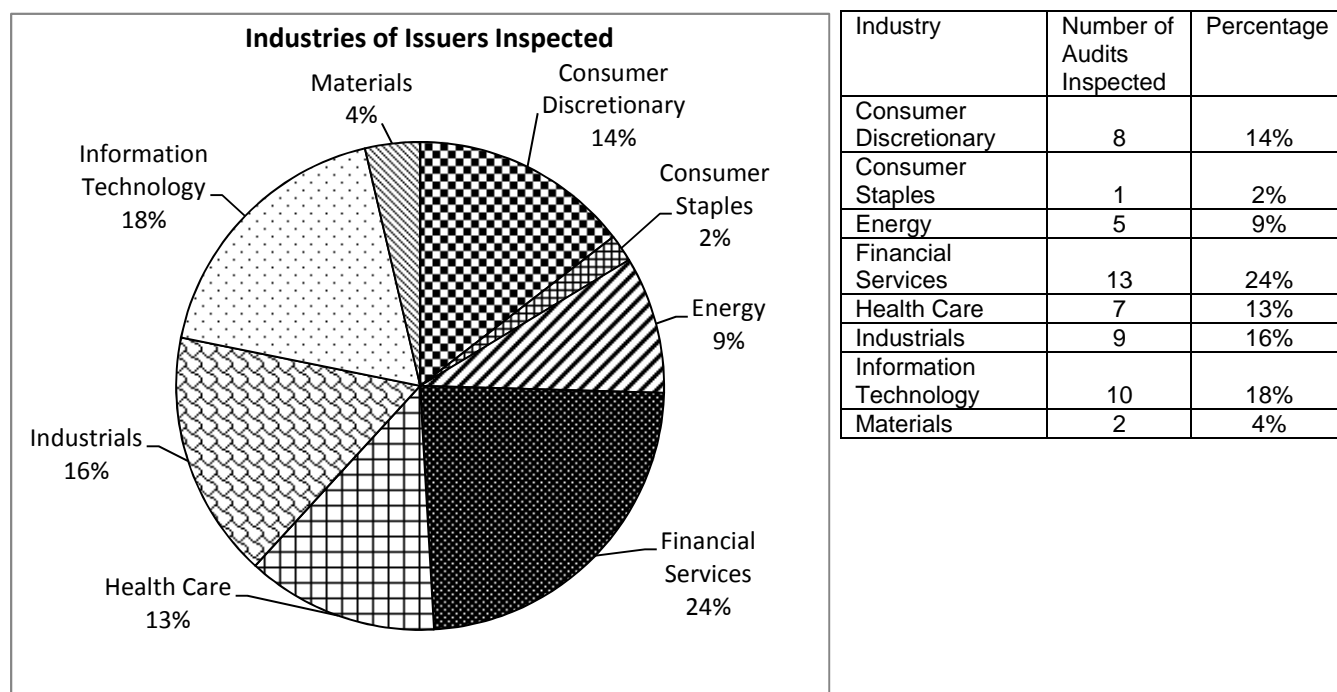
<sup>5</sup> The majority of industry sector data is based on Global Industry Classification Standard ("GICS") data obtained from Standard & Poor's ("S&P"). In instances where GICS for an issuer is not available from S&P, classifications are assigned based upon North American Industry Classification System data.

<sup>6</sup> Where identifying the industry of the issuer may enhance the understanding of the description of a deficiency in Part I.A, industry information is also provided there, unless doing so would have the effect of making the issuer identifiable.

**C. Data Related to the Issuer Audits Selected for Inspection**

**C.1. Industries of Issuers Inspected**

The chart below categorizes the 55 issuers whose audits were inspected in 2015, based on the issuer's industry.<sup>7</sup>

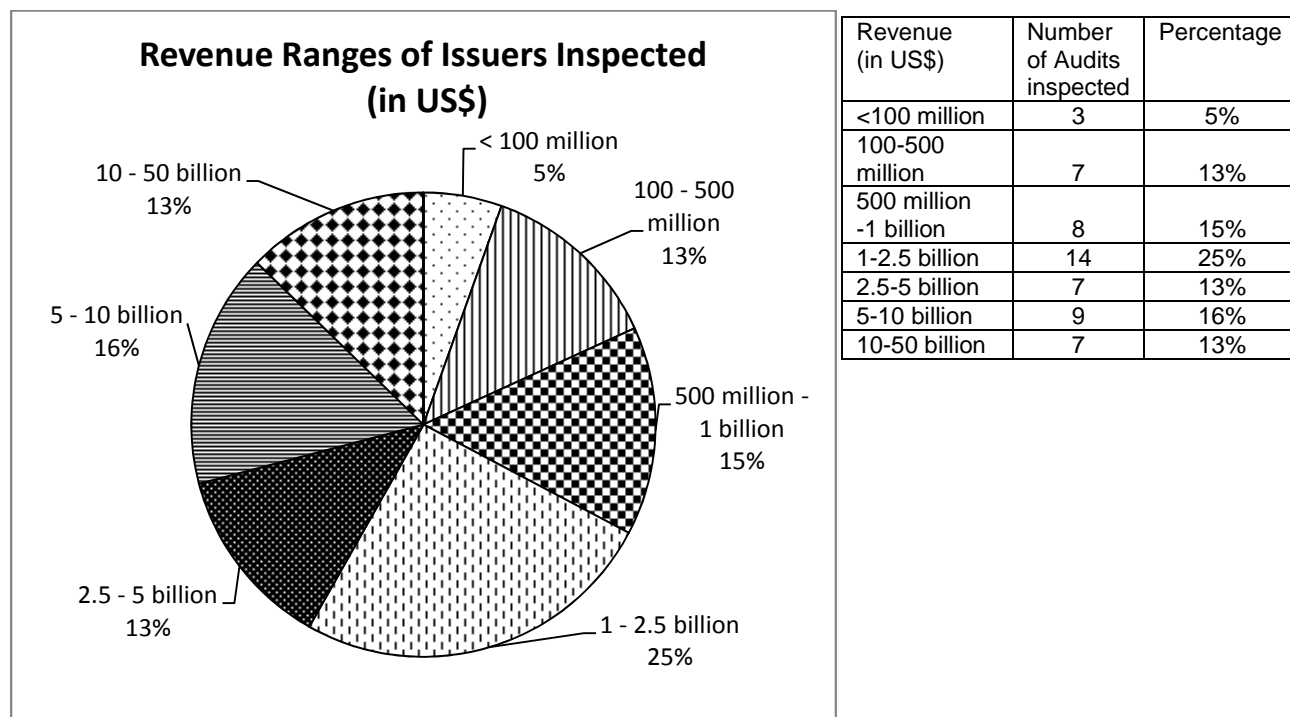


<sup>7</sup> See Footnote 5 for additional information on how industry sectors were classified.



C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 55 issuers whose audits were inspected in 2015.<sup>8</sup> This presentation of revenue data is intended to provide information about the size of issuer audits that were inspected and is not indicative of whether the inspection included a review of the Firm's auditing of revenue in the issuer audits selected for review.



<sup>8</sup> The revenue amounts reflected in the chart are for the issuer's fiscal year end that corresponds to the audit inspected by the PCAOB. The revenue amounts were obtained from S&P and reflect a standardized approach to presenting revenue amounts.

**D. Information Concerning PCAOB Inspections that is Generally Applicable to Annually Inspected Firms**

Board inspections include reviews of certain portions of selected audit work performed by the inspected firm and reviews of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects 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. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

**D.1. Reviews of Audit Work**

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of ICFR. For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,<sup>9</sup> as well as a

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<sup>9</sup> When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with the applicable

firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection of an annually inspected firm does not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS 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. In reaching its conclusions, an inspection team considers whether audit documentation or any other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

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financial reporting framework, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.<sup>10</sup>

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on 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.

#### D.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides that an auditing firm has a responsibility to ensure that its personnel comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audits. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable

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<sup>10</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. In addition, 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 for purposes of imposing legal liability.

assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion may indicate a defect or potential defect in a firm's quality control system.<sup>11</sup> If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;<sup>12</sup> related firm methodology, guidance, and practices; and possible root causes.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. The inspection team customizes the procedures it performs with respect to the firm's practices, policies, and processes related to audit quality, bearing in mind the firm's structure, procedures performed in prior inspections, past and current inspection observations, an assessment of risk related to each area, and other factors. The areas generally considered for review include (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 issuer audit engagements, 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 audits; and

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<sup>11</sup> Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report does not discuss every audit deficiency the inspection team identified.

<sup>12</sup> An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

(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 defects or potential defects in quality control. A description of the procedures generally applied to these areas is below.

D.2.a. Review of Management Structure and Processes, Including the Tone at the Top

Procedures in this area are designed to focus on (1) how management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance and (2) whether actions and communications by the firm's leadership – the tone at the top – demonstrate a commitment to audit quality. To assess this area, the inspection team may interview members of the firm's leadership and review significant management reports and documents, as well as information regarding financial metrics and other processes that the firm uses to plan and evaluate its business.

D.2.b. Review of Practices for Partner Management, Including Allocation of Partner Resources and Partner Evaluation, Compensation, Admission, and Disciplinary Actions

Procedures in this area are designed to focus on (1) 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 distinct from marketing or other activities of the firm; (2) the firm's processes for allocating its partner resources; and (3) the accountability and responsibilities of the different levels of firm management with respect to partner management. The inspection team may interview members of the firm's management and review documentation related to certain of these topics. In addition, the inspection team's evaluation may include the results of interviews of audit partners regarding their responsibilities and allocation of time. Further, the inspection team may review a sample of partners' personnel files.



D.2.c. Review of Policies and Procedures for Considering and Addressing the Risks Involved in Accepting and Retaining Issuer Audit Engagements, Including the Application of the Firm's Risk-Rating System

The inspection team may consider the firm's documented policies and procedures in this area. In addition, the inspection team may select certain issuer audits to (1) evaluate compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the issuer audit engagements and (2) observe whether the audit procedures were responsive to the risks identified during the firm's process.

D.2.d. Review of Processes Related to a Firm's Use of Audit Work that the Firm's Foreign Affiliates Perform on the Foreign Operations of the Firm's U.S. Issuer Audits

The inspection team may review the firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the firm's U.S. issuer audits, review available information relating to the most recent internal inspections of foreign affiliated firms, interview members of the firm's leadership, and review the U.S. engagement teams' supervision concerning, and procedures for control of, the audit work that the firm's foreign affiliates performed on a sample of audits.

D.2.e. Review of a 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 Defects or Potential Defects in Quality Control

D.2.e.i. Review of Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance

Procedures in this area are 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 may interview members of the firm's management and review documents relating to the firm's identification and evaluation of, and response to, possible indicators of deficiencies in audit performance. In addition, the inspection team may review documents related to the design, operation, and



evaluation of findings of the firm's internal inspection program, and may compare the results of its review of audit work to those from the internal inspection's review of the same audit work.

D.2.e.ii. Review of Response to Defects or Potential Defects in Quality Control

The inspection team may review steps the firm has taken to address possible quality control deficiencies and assess the design and effectiveness of the underlying processes. In addition, the inspection team may inspect audits of issuers whose audits had been reviewed during previous PCAOB inspections of the firm to ascertain whether the audit procedures in areas with previous deficiencies have improved.

D.2.e.iii. Review of Certain Other Policies and Procedures Related to Monitoring Audit Quality

The inspection team may assess policies, procedures, and guidance related to aspects of independence requirements and the firm's consultation processes, as well as the firm's compliance with these requirements and processes. In addition, the inspection team may review documents, including certain newly issued policies and procedures, and interview firm management to consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

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**

**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>13</sup>

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<sup>13</sup> The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. 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.



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Public Company Accounting Oversight Board  
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October 3, 2016

**Response to Part I of the Draft Report on the 2015 Inspection of Ernst & Young LLP**

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board (the "PCAOB") regarding Part I of the Draft Report on the 2015 Inspection of Ernst & Young LLP (the "Report").

We have thoroughly evaluated the matters described in Part I – *Inspection Procedures and Certain Observations* of the Report and have taken actions to address findings in accordance with PCAOB standards and our policies.

The PCAOB's inspection process assists us in identifying areas where we can continue to improve audit quality. We respect and benefit from this process as it aids us in fulfilling our responsibilities to investors, other stakeholders, and the capital markets generally.

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,

Stephen R. Howe, Jr.  
Chairman and Managing Partner

Francis C. Mahoney  
Vice Chair Assurance Services

**APPENDIX C**

**AUDITING STANDARDS REFERENCED IN PART I**

This appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this appendix, and any other Notes, are from the original auditing standards that are referenced. While this appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at <http://pcaobus.org/STANDARDS/Pages/default.aspx>.

<b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b>		
<b>USING A TOP-DOWN APPROACH</b>		
<b>Identifying Entity-Level Controls</b>		
AS No. 5.22	The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.	Issuer H
<b>Understanding Likely Sources of Misstatement</b>		
AS No. 5.34	<p>To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –</p> <ul style="list-style-type: none"> <li>• Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;</li> <li>• Verify that the auditor has identified the points within the company's processes at which a misstatement - including a misstatement due to fraud - could arise that, individually or in combination with other misstatements, would be material;</li> <li>• Identify the controls that management has</li> </ul>	Issuer A

<b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b>		
	<p>implemented to address these potential misstatements; and</p> <ul style="list-style-type: none"> <li>Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.</li> </ul>	
<b>Selecting Controls to Test</b>		
AS No. 5.39	The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.	Issuers A, B, C, D, E, G, H, and P
<b>TESTING CONTROLS</b>		
<b>Testing Design Effectiveness</b>		
AS No. 5.42	<p>The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.</p> <p>Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.</p>	Issuers A, B, C, D, E, F, I, J, L, and O
<b>Testing Operating Effectiveness</b>		
AS No. 5.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.	Issuers A, B, C, D, E, F, I, J, K, L, and O

<b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b>		
	Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	
<b>EVALUATING IDENTIFIED DEFICIENCIES</b>		
AS No. 5.62	The auditor must evaluate the severity of each control <b>deficiency</b> that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.	Issuer A
AS No. 5.64	The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.	Issuer B
AS No. 5.68	The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.	Issuer B
<b>APPENDIX B – SPECIAL TOPICS</b>		
<b>Multiple Locations Scoping Decisions</b>		
AS No. 5.B10	<p>In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.</p> <p>Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material</p>	Issuers A, B, H, and K



<b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b>		
	misstatement to the company's consolidated financial statements.	
AS No. 5.B11	In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.	Issuer H

<b>AS No. 9, Audit Planning</b>		
<b>Planning an Audit</b>		
<b>MULTI-LOCATION ENGAGEMENTS</b>		
AS No. 9.11	In an audit of the financial statements of a company with operations in multiple locations or business units, <sup>13/</sup> the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.	Issuer A, F, and H
<b>Footnote to AS No. 9.11</b>		
<sup>13/</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.		
AS No. 9.12	Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the	Issuer A, F, and H

**AS No. 9, Audit Planning**

	<p>necessary audit procedures include:</p> <ul style="list-style-type: none"> <li>a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;<sup>14/</sup></li> <li>b. The materiality of the location or business unit;<sup>15/</sup></li> <li>c. The specific risks associated with the location or business unit that present a reasonable possibility<sup>16/</sup> of material misstatement to the company's consolidated financial statements;</li> <li>d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;</li> <li>e. The degree of centralization of records or information processing;</li> <li>f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and</li> <li>g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.</li> </ul> <p>Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5<sup>17/</sup> for considerations when a company has multiple locations or business units.</p>	
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Footnotes to AS No. 9.12

<sup>14/</sup> Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

**AS No. 9, Audit Planning**

<sup>15/</sup> Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

<sup>16/</sup> There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

<sup>17/</sup> Paragraphs B10-B16 of Auditing Standard No. 5.

**AS No. 13, The Auditor's Responses to the Risks of Material Misstatement**

<b>RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF AUDIT PROCEDURES</b>		
AS No. 13.8	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers B, C, K, and M
<b>TESTING CONTROLS</b>		
<b>Testing Controls in an Audit of Financial Statements</b>		
AS No. 13.16	<i>Controls to be Tested.</i> If the auditor plans to assess control risk at less than the maximum by relying on controls, <sup>12/</sup> and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire <b>period of reliance</b> . <sup>13/</sup> However, the auditor is not required to assess control risk at less than the maximum for <i>all</i> relevant assertions and, for a variety of reasons, the auditor may choose not to do so.	Issuers C and G

Footnotes to AS No. 13.16

<sup>12/</sup> Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

**AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement***

<sup>13/</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

AS No. 13.18	<p><i>Evidence about the Effectiveness of Controls in the Audit of Financial Statements.</i> In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.</p>	Issuers C and G
<b>SUBSTANTIVE PROCEDURES</b>		
AS No. 13.37	<p>As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.</p>	Issuers C and G
<b>Timing of Substantive Procedures</b>		
AS No. 13.45	<p>When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.</p>	Issuer A

<b>AS No. 14, <i>Evaluating Audit Results</i></b>		
<b>EVALUATING THE RESULTS OF THE AUDIT OF FINANCIAL STATEMENTS</b>		
AS No. 14.3	In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.	Issuers I and L
<b>Evaluating the Presentation of the Financial Statements, Including the Disclosures</b>		
AS No. 14.30	<p>The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.</p> <p>Note: AU sec. 411, <i>The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles</i>, establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, <i>Evaluating Consistency of Financial Statements</i>, establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements.</p> <p>Note: The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.</p>	Issuer C

<b>AS No. 15, Audit Evidence</b>		
<b>SUFFICIENT APPROPRIATE AUDIT EVIDENCE</b>		
<b>Using Information Produced by the Company</b>		
AS No. 15.10	<p>When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:<sup>3/</sup></p> <ul style="list-style-type: none"> <li>• Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and</li> <li>• Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.</li> </ul>	Issuers B and G
<p><u>Footnote to AS No. 15.10</u></p> <p><sup>3/</sup> When using the work of a specialist engaged or employed by management, <u>see</u> AU sec. 336, <i>Using the Work of a Specialist</i>. When using information produced by a service organization or a service auditor's report as audit evidence, <u>see</u> AU sec. 324, <i>Service Organizations</i>, and for integrated audits, <u>see</u> Auditing Standard No. 5, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>.</p>		

<b>AU 328, Auditing Fair Value Measurements and Disclosures</b>		
<b>TESTING THE ENTITY'S FAIR VALUE MEASUREMENTS AND DISCLOSURES</b>		
AU 328.23	<p>Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs .26 through .39), (b) developing independent fair value estimates for corroborative purposes (see paragraph .40), or (c) reviewing subsequent events and transactions (see</p>	Issuer N

<b>AU 328, Auditing Fair Value Measurements and Disclosures</b>		
	paragraphs .41 and .42).	
<b>Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data</b>		
AU 328.26	<p>The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:</p> <ul style="list-style-type: none"> <li>a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).</li> <li>b. The fair value measurement was determined using an appropriate model, if applicable.</li> <li>c. Management used relevant information that was reasonably available at the time.</li> </ul>	Issuers A, B, D, I, J, and L
AU 328.28	<p>Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.</p>	Issuers A, B, D, I, J, and L
AU 328.31	<p>Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.</p>	Issuers B, D, I, J, and L
AU 328.36	<p>To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),<sup>in 5</sup> individually and taken as a whole, need to be realistic and consistent with:</p> <ul style="list-style-type: none"> <li>a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances;</li> <li>b. Existing market information;</li> </ul>	Issuers B, D, I, J, and L



<b>AU 328, Auditing Fair Value Measurements and Disclosures</b>		
	<p>c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies;</p> <p>d. Assumptions made in prior periods, if appropriate;</p> <p>e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;</p> <p>f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and</p> <p>g. The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate.</p> <p>Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.</p>	
Disclosures About Fair Values		
AU 328.43	<p>The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.<sup>fn 8</sup> Disclosure of fair value information is an important aspect of financial statements. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required under GAAP, some entities disclose voluntary additional fair value information in the notes to the financial statements.</p>	Issuer N
Footnote to AU 328.36		
<p><sup>fn 8</sup> The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).</p>		

<b>AU 329, Substantive Analytical Procedures</b>		
AU 329.05	<p>Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The</p>	Issuer A

<b>AU 329, Substantive Analytical Procedures</b>		
	<p>auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:</p> <ul style="list-style-type: none"> <li>a. Financial information for comparable prior period(s) giving consideration to known changes</li> <li>b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data</li> <li>c. Relationships among elements of financial information within the period</li> <li>d. Information regarding the industry in which the client operates—for example, gross margin information</li> <li>e. Relationships of financial information with relevant nonfinancial information</li> </ul>	
<b>ANALYTICAL PROCEDURES USED AS SUBSTANTIVE TESTS</b>		
<b>Precision of the Expectation</b>		
AU 329.17	<p>The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.</p>	Issuers B, F, and G
<b>Investigation and Evaluation of Significant Differences</b>		
AU 329.20	<p>In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the</p>	Issuer A

<b>AU 329, Substantive Analytical Procedures</b>		
	possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.	
AU 329.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, Evaluating Audit Results.)	Issuers A, B, and F

<b>AU 331, Inventories</b>		
<b>INVENTORIES</b>		
AU 331.11	In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [Revised, June 1981, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 39.]	Issuer E

<b>AU 341, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i></b>		
<b>CONSIDERATION OF MANAGEMENT'S PLANS</b>		
AU 341.09	<p>When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information. The auditor should give particular attention to assumptions that are—</p> <ul style="list-style-type: none"> <li>• Material to the prospective financial information.</li> <li>• Especially sensitive or susceptible to change.</li> <li>• Inconsistent with historical trends.</li> </ul> <p>The auditor's consideration should be based on knowledge of the entity, its business, and its management and should include (a) reading of the prospective financial information and the underlying assumptions and (b) comparing prospective financial information in prior periods with actual results and comparing prospective information for the current period with results achieved to date. If the auditor becomes aware of factors, the effects of which are not reflected in such prospective financial information, he should discuss those factors with management and, if necessary, request revision of the prospective financial information.</p>	Issuer D

<b>AU 342, <i>Auditing Accounting Estimates</i></b>		
<b>EVALUATING ACCOUNTING ESTIMATES</b>		
<b>Evaluating Reasonableness</b>		
AU 342.11	<p>Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:</p> <ul style="list-style-type: none"> <li>a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.</li> <li>b. Identify the sources of data and factors that management used in forming the assumptions,</li> </ul>	Issuers B, D, and E

<b>AU 342, Auditing Accounting Estimates</b>		
	<p>and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.</p> <ul style="list-style-type: none"> <li>c. Consider whether there are additional key factors or alternative assumptions about the factors.</li> <li>d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.</li> <li>e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.</li> <li>f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.</li> <li>g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.</li> <li>h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the Work of a Specialist).</li> <li>i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.</li> </ul>	

<b>AU 350, Audit Sampling</b>		
<b>Sampling In Substantive Tests Of Details</b>		
<b>Planning Samples</b>		
AU 350.19	<p>The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases</p>	Issuer G

<b>AU 350, Audit Sampling</b>		
	and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details. <sup>fn 3</sup> Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	
<u>Footnote to AU 350.19</u>		
<p><sup>fn 3</sup> Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.</p>		
AU 350.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.	Issuer G
AU 350.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuer G
<b>SAMPLING IN SUBSTANTIVE TESTS OF DETAILS</b>		
<b>Sample Selection</b>		
AU 350.24	Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example,	Issuer C

<b>AU 350, Audit Sampling</b>		
	haphazard and random-based selection of items represents two means of obtaining such samples. <sup>fn 4</sup>	
Footnote to AU 350.24		
<sup>fn 4</sup> Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.		
<b>SAMPLING IN TESTS OF CONTROLS</b>		
<b>Performance and Evaluation</b>		
AU 350.40	Auditing procedures that are appropriate to achieve the objective of the test of controls should be applied to each sample item. If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and he should ordinarily consider those selected items to be deviations from the prescribed policy or procedure for the purpose of evaluating the sample.	Issuer K



**APPENDIX D**

**REORGANIZED STANDARDS REFERENCED IN REPORT**

On March 31, 2015, the PCAOB adopted the reorganization of its auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015). On September 17, 2015, the SEC approved the PCAOB's adoption of the reorganization. The reorganized standards will be effective as of December 31, 2016. The citations to PCAOB auditing standards included in this report use the numbering system and titles of standards that were in effect at the time of the primary inspection procedures. This table provides the section numbers of those standards included in Part I of this report as reorganized, as well as the titles of the standards both before and after the reorganization. The complete standards are available on the PCAOB's website at <http://pcaobus.org/STANDARDS/Pages/default.aspx>.

<b>Auditing Standards – before the reorganization</b>		<b>Auditing Standards – as reorganized</b>	
AS No. 3	<i>Audit Documentation</i>	AS 1215	<i>Audit Documentation</i>
AS No. 5	<i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>	AS 2201	<i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>
AS No. 9	<i>Audit Planning</i>	AS 2101	<i>Audit Planning</i>
AS No. 13	<i>The Auditor's Responses to the Risks of Material Misstatement</i>	AS 2301	<i>The Auditor's Responses to the Risks of Material Misstatement</i>
AS No. 14	<i>Evaluating Audit Results</i>	AS 2810	<i>Evaluating Audit Results</i>
AS No. 15	<i>Audit Evidence</i>	AS 1105	<i>Audit Evidence</i>
AU 230	<i>Due Professional Care in the Performance of Work</i>	AS 1015	<i>Due Professional Care in the Performance of Work</i>
AU 328	<i>Auditing Fair Value Measurements and Disclosures</i>	AS 2502	<i>Auditing Fair Value Measurements and Disclosures</i>

<b>Auditing Standards – before the reorganization</b>		<b>Auditing Standards – as reorganized</b>	
AU 329	<i>Substantive Analytical Procedures</i>	AS 2305	<i>Substantive Analytical Procedures</i>
AU 331	<i>Inventories</i>	AS 2510	<i>Auditing Inventories</i>
AU 341	<i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i>	AS 2415	<i>Consideration of an Entity's Ability to Continue as a Going Concern</i>
AU 342	<i>Auditing Accounting Estimates</i>	AS 2501	<i>Auditing Accounting Estimates</i>
AU 350	<i>Audit Sampling</i>	AS 2315	<i>Audit Sampling</i>