

## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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|-----------------------------|---|--------------------------------|
| In the Matter of            | ) | PCAOB Release No. 104-2019-003 |
| KPMG LLP's                  | ) |                                |
| Quality Control Remediation | ) |                                |
| Submissions                 | ) | January 25, 2019               |
|                             | ) |                                |
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### I.

The Public Company Accounting Oversight Board ("Board" or "PCAOB") has evaluated the submissions of KPMG LLP ("Firm") pursuant to PCAOB Rule 4009(a) for the remediation periods ended October 15, 2016 and November 9, 2017 concerning the Firm's efforts to address certain quality control criticisms included in the nonpublic portions of the Board's October 15, 2015 and November 9, 2016 inspection reports on the Firm ("Reports"). The Board has determined that as of October 15, 2016 and November 9, 2017, respectively, the Firm had not addressed certain criticisms in the Reports to the Board's satisfaction. Accordingly, pursuant to Section 104(g)(2) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 4009(d), the Board is making public the portions of the Reports that deal with those criticisms.<sup>1</sup>

The Firm has notified the Board that it will not seek Securities and Exchange Commission review of the determination, which the Firm has a right to do under the Act and Commission rules. The Firm has requested that a related statement by the Firm be attached as an Appendix to this release, and the Board has granted that request. By allowing the Firm's statement to be attached as an Appendix to this release, however, the Board is not endorsing, confirming, or adopting as the Board's view any element of the Firm's statement.

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<sup>1</sup> Those portions of the Reports are now included in the versions of the Reports that are publicly available on the Board's website. Observations in Board inspection reports are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability.

**II.**

The quality control remediation process is central to the Board's efforts to oversee firms' efforts to improve the quality of their audits and thereby better protect investors. The Board therefore takes very seriously the importance of firms making sufficient progress on quality control issues identified in an inspection report in the 12 months following the report. The Board devotes considerable time and resources (particularly with the largest firms, which are inspected annually) to critically evaluating whether a firm did in fact make sufficient progress in that period. The Board makes the relevant criticisms public when a firm has failed to do so to the Board's satisfaction.

It is not unusual for an inspection report to include nonpublic criticisms of several aspects of a firm's system of quality control. Any Board judgment that results in later public disclosure is a judgment about whether a firm has made sufficient effort and progress to address the particular criticisms articulated in the report on that firm in the 12 months immediately following the report date. It is not a broad judgment about the effectiveness of a firm's system of quality control compared to those of other firms, and it does not signify anything about the merits of any additional efforts a firm may have made to address the criticisms after the 12-month period.

ISSUED BY THE BOARD.

/s/ Phoebe Brown

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Phoebe W. Brown  
Secretary

January 25, 2019



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## **Statement of KPMG LLP on the PCAOB's January 25, 2019 Release No. 104-2019-003**

Nothing is more important to KPMG LLP than fulfilling our critical role in the capital markets by performing high-quality audits and consistently executing on our responsibilities to audit committees and investors. We recognize and support the Public Company Accounting Oversight Board's ("PCAOB") mission of promoting high quality auditing, and we are committed to resolving the concerns identified in the PCAOB's inspection reports. We appreciate the professionalism and commitment of the PCAOB and its staff, and value the important role the PCAOB plays in improving audit quality at our firm and across the profession.

The PCAOB has made public portions of Part II of its Reports on the 2014 and 2015 Inspections of KPMG LLP (the "Reports") because the PCAOB determined that the firm had not satisfactorily addressed the quality control criticisms within the 12-month period after the publication of the Reports. We agree with the PCAOB's determination.

We take seriously our failure to timely address these criticisms. Notably, during a significant portion of the applicable periods, remediation efforts were being led by individuals who engaged in conduct that undermined the integrity of the regulatory process through their inappropriate use of PCAOB confidential information. The conduct of these individuals was contrary to the firm's Code of Conduct, what we expect and demand of our people, and intolerable. Upon learning of such conduct through an internal source in February 2017, the firm took immediate remedial actions that clearly demonstrated the firm's commitment to professional integrity, audit quality and the regulatory process. We immediately informed the PCAOB and the Securities and Exchange Commission ("SEC") and opened an investigation conducted by outside counsel. Since then, when information came to the firm's attention that indicated that individuals, including those responsible for leading the Audit practice at the time, had engaged in conduct contrary to both the letter and the spirit of the regulatory process, our Code of Conduct, or the firm's system of internal controls, the firm took appropriate remedial action, including separating responsible individuals from the firm.

Over the last 18 months, we have made significant changes to our audit leadership team, including the appointment of a new Vice Chair-Audit, a new National Managing Partner-Audit Quality and Professional Practice, a new National Managing Partner of Audit Operations, a new Chief Auditor, and a new Inspections Leader. All were chosen for their roles, first and foremost, because of their demonstrated record of sound judgment, professionalism, ethics, integrity, as well as their ability to inspire the trust of our people and command confidence from our clients. We also enhanced our overall governance process with the addition of two independent directors to our Board of Directors. In addition, over the last year we undertook an enterprise-wide culture assessment with external experts in organizational ethics and culture change, to explore how we can integrate culture more explicitly into our sustainable operating model. We listened, collected and analyzed responses



to inform an integrated, comprehensive and multidisciplinary approach to achieve progress toward improving our firm's culture. We believe that our new leaders and directors, our focus on our culture and the quality focused investments and audit quality actions described below, make clear a new tone at the top and underscore our commitment to audit quality.

#### *Internal control and estimates*

We have made significant investments in a new audit methodology and the related workflow technology that supports the execution of our audits. These investments in particular are specifically focused on auditing internal controls over financial reporting and estimates. These investments, to be fully implemented in 2020, will ensure a clear alignment of our audit methodology with the auditing standards and the facilitation of audit execution through a new technology platform. Certain elements of the methodology related to risk assessment have been accelerated into 2018 to expedite improvement in the auditing of internal controls over financial reporting and estimates.

#### *Professional skepticism, supervision and review, and engagement quality control review*

We recognize the importance of our responsibilities related to professional skepticism, supervision and review, and engagement quality control reviews ("EQCR"), and we have increased training, clarified roles, modified processes, and enhanced accountability to ensure improved execution in these areas. For example, we have enhanced our workflow to require and document early partner and EQCR involvement in key areas of the audit, bringing essential expertise and a critical viewpoint to all phases of the work.

#### *Monitoring programs*

We have changed our approach to engagement monitoring and the oversight of our Inspections Group. This group now reports outside of our Audit practice and into our Vice Chairman – Legal, Risk and Regulatory. It serves no engagement support role (that role now being confined to the Audit practice itself), ensuring that its activities are directed solely to a critical assessment of our professionals' performance. The output of our own monitoring and the results of external inspections are synthesized through our root cause analysis to ensure that we develop remedial actions that are responsive to our control deficiencies and meet the standards required of those actions.



*Accountability*

Under new leadership, responsibilities for audit quality have been clearly defined for roles from the engagement partner to the Chairman and CEO, which has given us a framework to ensure accountability for audit quality beyond the engagement team. We have implemented performance assessment and compensation processes to align with those roles and responsibilities. More broadly, we have initiated a project to more clearly delineate core competencies by organizational level. Our training curriculum and promotional processes will align directly to this core competency framework.

*Our commitment to continuous improvement*

We define audit quality as the outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards, within a strong system of quality controls. We have gained global alignment on this definition to ensure our professionals have a clear vision of our view of quality at both the engagement level and related to our overall system of quality controls. Because the quality of each audit rests on our foundational quality controls, we are building a process to document and continually evaluate our overall system of audit quality controls and our implementation of the quality control standards applicable to our work.

We believe that the significant actions we have taken in the past 18 months demonstrate that we are dedicated to reinforcing a tone at the top that reflects our unwavering commitment to improved audit quality and respect for the regulatory process. We require our professionals to exhibit the highest level of professionalism and integrity and to embrace their roles in driving audit quality and improving our system of audit quality control. We take seriously our responsibility to the capital markets and are committed to continuously improving our firm and working constructively with the PCAOB to maintain the public's trust.

Very truly yours,

KPMG LLP

Lynne M. Doughtie  
*Chairman and Chief Executive Officer*

Frank E. Casal  
*Vice Chair - Audit*

**Report on**  
**2015 Inspection of KPMG LLP**  
**(Headquartered in New York, New York)**

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

**November 9, 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 KPMG LLP**

### Preface

In 2015, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm KPMG 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 July 2016. The inspection team performed field work at the Firm's National Office and at 26 of its approximately 80 U.S. practice offices.

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

The inspection procedures included reviews of portions of 49 issuer audits performed by the Firm and a review of the Firm's audit work on three other issuer audit engagements in which the Firm played a role but was not the principal auditor.

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.20, below.

*Effects on Audit Opinions*

Of the 20 issuer audits that appear in Part I.A, deficiencies in 17 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, seven 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 | 11                      |
| Deficiencies included in Part I.A related to the financial statement audit only                    | 3                       |
| Deficiencies included in Part I.A related to the ICFR audit only                                   | 6                       |
|  |                         |
| <b>Total</b>   | <b>20</b>               |

*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>14 Audits:</u><br>Issuers A, B, C, D, E, F, G, I, L, M, N, P, Q, and S |
| Failure to sufficiently test controls over, or sufficiently test, the accuracy and completeness of issuer-produced data or reports.                               | <u>8 Audits:</u><br>Issuers B, C, D, E, F, G, J, and O                    |
| Failure to perform substantive procedures to obtain sufficient evidence as a result of relying too heavily on controls (due to deficiencies in testing controls). | <u>7 Audits:</u><br>Issuers A, B, D, F, J, L, and O                       |

*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 Firm failed to perform sufficient procedures related to the issuer's revenue and inventory. Specifically –
  - The issuer generated revenue and held inventory at numerous locations. In determining the scope of its tests of controls, the Firm assumed that the controls over revenue and inventory were homogeneous at the locations, except for certain inventory-costing controls. Based on this assumption, the Firm reduced the number of locations selected for testing. The Firm and the issuer identified multiple control deficiencies related to the same controls at several of the locations tested, but these control deficiencies were not the same at each location. The Firm failed to consider whether these dissimilar control deficiencies indicated that the Firm's assumption

- of homogenous controls was incorrect. (AS No. 5, paragraphs 48 and B10)
- The Firm failed to perform sufficient substantive procedures to test revenue and inventory.
    - The Firm performed substantive procedures to test the existence of inventory at certain of the issuer's locations. The remaining locations, at which the Firm performed no procedures, represented over 30 percent of total inventory and presented a reasonable possibility of material misstatement. The Firm determined this extent of testing based on the unsupported assumption of homogeneous controls over inventory that is described above. (AS No. 9, paragraphs 11 and 12)
    - For the locations at which substantive procedures were performed related to revenue and inventory, the Firm designed its substantive procedures – including sample sizes – based on a level of control reliance that was not supported due to the unsupported reduction in the number of locations selected for testing that is discussed above. As a result, the sample sizes the Firm used to test revenue and inventory were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)
  - The Firm failed to perform sufficient procedures related to the issuer's deferred tax assets. Specifically –
    - The Firm selected for testing one control over foreign deferred tax assets. This control consisted of the reconciliation of amounts from tax packages prepared by the issuer's foreign subsidiaries and supporting schedules provided by those subsidiaries. This control, however, did not address the risks that the amounts in the tax packages and supporting schedules were not valid deferred tax assets or were not appropriately valued, and the Firm failed to

identify and test any other controls that addressed those risks. (AS No. 5, paragraph 39)

- The Firm selected for testing a control that included management's review of a financial forecast used in the analysis of the deferred tax asset valuation allowance. The Firm's testing of this control was limited to inquiring of the control owner and inspecting an industry report that constituted one of several inputs the control owner used to form his expectations. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the nature of the review procedures performed by the control owner, including (1) whether the control owner evaluated if the forecast was prepared at an appropriate level of disaggregation, (2) the expectations applied in the review (other than by inspecting the industry report noted above), and (3) the criteria used by the control owner to identify items for follow up and the resolution of such matters. (AS No. 5, paragraphs 42 and 44)
- To test the domestic deferred tax asset valuation allowance, the Firm developed two independent expectations of the estimated future tax benefit. The significant assumptions that the Firm used to develop its independent expectations were revenue growth rates, years of profitability, operating expenses, and the percentage of profit allocated to domestic operations, and the Firm used industry data as well as historical data for certain time periods to develop these assumptions. The Firm failed to support the appropriateness of the data used and assumptions made in developing these expectations. In addition, for one of the independent expectations, the Firm failed to identify that the spreadsheet that it used contained formula errors that affected the calculated expected tax benefit by an amount that exceeded the Firm's established level of materiality. (AU 342, paragraph .12)

#### A.2. Issuer B

In this audit of an issuer that generates its revenue through the sale of online advertising, 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 revenue and accounts receivable. Specifically –
  - The Firm's procedures related to revenue generated at certain of the issuer's locations, which in the aggregate represented a significant portion of total revenue and accounts receivable and presented a reasonable possibility of material misstatement, were limited to testing certain entity-level controls. These controls consisted of (1) a review of subsidiaries' comparisons of recorded to forecasted operating results and changes in balance sheet amounts, with investigation of variances over certain thresholds; (2) comparisons of quarterly consolidated balance sheets to the previous year-end consolidated balance sheet and the investigation of variances over a threshold; (3) comparisons of quarterly consolidated income statements to forecasted amounts and the investigation of variances over a threshold; and (4) certification by location personnel that their financial statements and balance sheet account reconciliations were accurate and complete.

The Firm's procedures to test these controls were insufficient, as they were limited to (1) inquiring of issuer personnel; (2) attending one meeting that constituted part of the operation of one of the controls; (3) observing evidence that the various elements of the controls had occurred; (4) determining whether explanations were provided for all variances over the controls' investigation thresholds; (5) tracing information to the general ledger, reports, and/or supporting documents; and (6) testing the mathematical accuracy of certain calculations. The Firm, however, failed to evaluate whether identified variances were appropriately investigated and resolved. As a result of this deficiency, the Firm's procedures related to controls over revenue generated at these locations were not sufficient. (AS No. 5, paragraphs 42, 44, and B10)

- The Firm failed to perform any substantive testing of revenue and accounts receivable at the locations described above. (AS No. 9, paragraphs 11 and 12)
- With respect to the locations for which the Firm tested process-level controls and performed substantive testing –
  - The Firm identified deficiencies in certain information technology general controls ("ITGCs") related to access to two applications that the issuer used to process revenue and accounts receivable, as well as access to data within these applications and a server supporting them. In evaluating these ITGC deficiencies, the Firm identified and tested compensating controls and concluded that the deficiencies, individually and in combination, did not rise to the level of a significant deficiency or material weakness. The Firm, however, failed to sufficiently evaluate these compensating controls. Specifically, for each control either (1) the Firm failed to identify that the compensating control was not designed to prevent or detect unauthorized changes to these applications and data, as the compensating control was focused on the approval of planned changes to the systems' code or (2) the compensating control was also affected by the ITGC deficiencies. (AS No. 5, paragraph 68)
  - As a result of the deficiencies in the Firm's testing of ITGCs that are described above, (1) the Firm's testing of certain application controls using a sample of one instance of the control's operation was not sufficient and (2) the Firm's reliance on the accuracy and completeness of certain data that were used in the operation of IT-dependent manual controls over revenue and accounts receivable was not supported. (AS No. 5, paragraphs 39, 46, and 47)
  - The Firm failed to perform sufficient substantive procedures to test certain revenue and accounts receivable, which represented the majority of total revenue and accounts receivable. Specifically, the Firm designed its substantive

procedures – including its sample sizes – to test this revenue and accounts receivable 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 sample sizes the Firm used to test this revenue and accounts receivable were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

- In testing the items within its sample of revenue transactions, the Firm relied on data about advertising activity that were generated electronically and that it obtained from the issuer's system. The Firm failed to sufficiently test controls over these data, due to the deficiencies described above, or otherwise test the accuracy and completeness of these data. (AS No. 15, paragraph 10)
- The Firm's procedures related to the valuation of intangible assets acquired during the year in business combinations were insufficient. Specifically –
  - The Firm selected for testing a control over the valuation of acquired intangible assets that consisted of management's review of the assumptions included in external valuation reports that were used to determine the fair value of such assets. The Firm's testing of this control was not sufficient. Specifically, the Firm limited its testing to (1) inquiring of management, (2) participating in calls between management and management's external valuation specialists that constituted part of the control, (3) reading issuer-prepared memoranda summarizing the transactions, and (4) noting management's thresholds for investigation and justification for certain assumptions. The Firm failed to evaluate (1) how the control owner determined that the prior acquisitions' assumptions that were used to form current expectations were appropriate for that purpose and (2) the appropriateness of the criteria the control owner used to identify items for follow up. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain



data used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to sufficiently test the fair value of the acquired technology and vendor-relationship intangible assets for certain acquisitions. The Firm compared certain significant inputs and assumptions to financial information from another business combination the issuer consummated during the year or information disclosed by other companies. The Firm's procedures did not include evaluating the reasonableness of these inputs and assumptions underlying the valuation of these assets beyond such comparisons. In addition, the Firm failed to test the accuracy and completeness of certain data used in the valuation of these intangible assets. (AU 328, paragraphs .26, .28, and .39)

### A.3. Issuer C

The Firm was engaged by the principal auditor of an issuer in the financial services industry to (1) audit the financial statements and ICFR of certain subsidiaries and a branch of the issuer, excluding certain centrally coordinated areas; and (2) perform certain procedures on the financial statements and ICFR of certain other components of the issuer to support the principal auditor's opinions on the consolidated financial statements and the effectiveness of ICFR of the issuer. The Firm failed in the following respects to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audits –

- The Firm's procedures related to the valuation and disclosure of investments and derivatives, including those without readily determinable fair values ("hard-to-value financial instruments"), for those components for which the Firm was instructed to perform full-scope audits, were not sufficient. Specifically –
  - The Firm identified the independent price verification activities that were executed by the issuer's independent pricing group ("IPG") as an important control over the valuation of investments and derivatives, and the Firm assessed this control as having a higher risk of failure. The Firm failed to sufficiently test this control, as follows –

- The Firm limited its procedures to (1) inquiring of the control owners; (2) reading the components' valuation policy; (3) obtaining a sample of pricing files; and (4) for certain investments and derivatives within these pricing files, verifying the mathematical accuracy of the underlying calculations, reading the pricing support obtained by IPG, and considering compliance with the valuation policy. The Firm failed to determine how IPG addressed variances between its results and those that it obtained from the issuer's traders, including by failing to evaluate the adjustments made to the recorded values of investments and derivatives as a result of IPG's review. (AS No. 5, paragraphs 42 and 44)
- The Firm identified a fraud risk related to the valuation of hard-to-value financial instruments. The issuer's IPG determined that certain of the issuer's hard-to-value financial instruments could not be covered by the independent price verification activities control because either there was no pricing information available or the pricing information that was available could not be determined to be reliable. The Firm, however, failed to test any controls that reviewed the valuation of these investments and derivatives. (AS No. 5, paragraph 39)
- The Firm failed to identify and test any controls over the accuracy and completeness of important data used in the performance of the independent price verification activities control as it related to derivatives. (AS No. 5, paragraph 39)
- The Firm failed to perform sufficient procedures to test the disclosure of investments and derivatives, including hard-to-value financial instruments, within the hierarchy set forth in the applicable financial reporting requirements. The Firm assessed control risk as high for the disclosure of these financial instruments. The Firm's procedures to evaluate the disclosure under the applicable hierarchy were limited to evaluating the levels within the hierarchy for product types in the aggregate. These procedures were

insufficient, as they did not take into account the possibility that the levels could be different within the various product types. (AU 328, paragraph .43)

- The issuer engaged in various activities related to securitizations of loans. With respect to securitizations involving the components for which the Firm was instructed to perform a full-scope audit, the Firm's procedures were not sufficient. Specifically, the Firm failed to obtain a sufficient understanding of the components' roles in these securitizations to determine whether it was necessary to identify and test controls over the accounting for current and past securitizations, including the evaluation of whether it was necessary to consolidate any of the entities involved in these securitizations. (AS No. 5, paragraphs 29 and 34)
- The Firm's procedures related to securitizations involving another component, for which the Firm was instructed to perform integrated audit procedures with respect to the related account balances, were not sufficient. Specifically –
  - The Firm selected for testing a control that consisted of management's review of these securitizations. The Firm limited its testing of the operating effectiveness of this control to (1) inquiring of the control owners, (2) reading a sample of memoranda that documented certain of management's considerations, and (3) obtaining documents supporting one securitization. These procedures did not include evaluating the nature of the steps that the control owners took to perform their review, as the Firm simply noted that elements of a review were documented. In addition, the Firm failed to identify and test any controls over the completeness of the population of securitizations that was reviewed pursuant to this control. (AS No. 5, paragraphs 39 and 44)
  - The Firm's substantive procedures to test these securitizations were not sufficient. Specifically, the Firm limited its procedures to (1) inquiring of management; (2) inspecting a spreadsheet indicating whether interest was retained in the securitizations and consolidation was necessary; and (3) obtaining a sample of memoranda that documented certain of management's

considerations and concluding that the memoranda included the background of the transaction, an analysis of the accounting treatment, and an accounting conclusion. The Firm failed to perform an evaluation of whether the transfers of the loans in the securitizations met the criteria to de-recognize the loans and whether the entities to which the loans were transferred met the non-consolidation criteria. In addition, the Firm failed to test the completeness of the population of securitizations from which it selected items for testing. (AS No. 14, paragraph 30; AU 350, paragraph .24)

A.4. Issuer D

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 –

- For the issuer's foreign locations, which represented a significant portion of total revenue and total inventory, the Firm's procedures related to controls over revenue and inventory were limited to testing certain entity-level controls. These controls consisted of (1) monthly meetings to discuss recorded results compared to the budget and strategic plan and to develop action plans as a result of those discussions, (2) quarterly comparisons of location trial balances to the corresponding prior-quarter amounts and the investigation of variances exceeding a threshold, and (3) monthly reconciliations of subsidiary ledgers to the general ledger for balance sheet accounts for which the balance exceeded a monetary threshold. The Firm's procedures to test these controls were insufficient, as its testing was limited to attending certain monthly meetings, inquiring of the control owners, and observing signatures as evidence of review of the reconciliations. The Firm failed to evaluate (1) whether the procedures in the first two controls described above were designed and operating in a manner that would prevent or detect misstatements in the revenue and inventory accounts rather than merely identifying and explaining differences and (2) whether the prior-period amounts, the budget, and the strategic plan information were appropriate bases for establishing expectations to identify matters for investigation. Further, although the Firm noted that the locations provided explanations of variances that

exceeded the established threshold and that the explanations appeared to be reasonable, the Firm failed to perform procedures to evaluate whether the control owners' consideration, investigation, and resolution of these matters were appropriate. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain reports that the issuer used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test revenue and inventory for certain of the issuer's foreign locations.
  - The Firm inappropriately determined that the entity-level controls, the testing of which is described above, mitigated the risks at various locations, and therefore performed no substantive testing of the existence of inventory at certain of these foreign locations. These foreign locations in the aggregate held a significant portion of the issuer's total inventory and presented a reasonable possibility of material misstatement. (AS No. 9, paragraphs 11 and 12)
  - The Firm designed its substantive procedures – including 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 sample sizes the Firm used to test revenue and inventory at some of the issuer's foreign locations were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

#### A.5. Issuer E

In this audit of an issuer in the financial services 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 identified a fraud risk related to the qualitative component of the allowance for loan losses ("ALL"), which represented a significant portion of the total ALL. The Firm failed to perform sufficient procedures with respect to the ALL. Specifically –

- During the year, the issuer experienced declines in its loan charge-offs and classified loans, and it decreased the quantitative and specific components of its ALL. The issuer disclosed that the quality of its loan portfolio had improved, noting improved loan underwriting standards, and that economic conditions had improved. The amount of the component of the issuer's ALL that captured non-quantitative and non-specific factors (the qualitative component), however, had increased, which appeared to be inconsistent with the matters described above. The Firm's procedures related to the qualitative component consisted of dual-purpose tests. As part of these tests, the Firm selected controls that consisted of management's review of the adjustments from the prior quarters that determined the qualitative component of the ALL. The Firm limited its testing of these controls to inspecting internal and external data and noting that each qualitative adjustment was within the range established by the issuer's policy. The Firm failed to evaluate whether these reviews, or other controls over the qualitative component, took into account all relevant matters, including those described above. In addition, in performing its substantive procedures, including the evaluation of the reasonableness of the qualitative adjustments and the total qualitative component, the Firm failed to take into account the matters described above. (AS No. 5, paragraphs 42 and 44; AU 342, paragraph .11)
- The Firm selected for testing a control that consisted of a review by an external party of the assigned loan grades for a sample of loans; the assigned loan grades were an important factor in estimating the ALL. This control operated only during the first quarter. The Firm selected for testing three additional controls to address the risk of material misstatement related to loan grades as of year end. Two of these three controls consisted of management's review of requested changes to loan grades and the third control consisted of a notification to loan officers of suggested loan grade changes. The Firm failed to sufficiently test these three controls. Specifically, the Firm failed to (1) identify and test any controls over the accuracy and completeness of certain data used in the performance of the two controls related to requested changes and (2) sufficiently test

the notification control, as it failed to obtain an understanding of how the loan officers evaluated the suggested loan grade changes. (AS No. 5, paragraphs 39 and 44)

- During the year, the issuer acquired a significant business. The Firm failed to perform sufficient tests of controls over business combinations. Specifically –
  - The Firm identified four significant deficiencies and one other deficiency in controls that it selected for testing over the accounting for business combinations. These deficiencies were not remediated at year end. The Firm failed to evaluate whether, in combination, these deficiencies constituted a material weakness. (AS No. 5, paragraph 62)
  - The Firm selected for testing another control that consisted of management's review and approval of the accounting policy for business combinations. Certain of the significant deficiencies identified above related to a lack of understanding of the accounting requirements related to business combinations on the part of the control owners, who were also the control owners of this control. The Firm failed to evaluate whether these significant deficiencies had implications for its consideration of whether the control owners possessed the necessary competence to effectively perform this control. (AS No. 5, paragraph 44)

A.6. Issuer F

In this audit of an issuer in the financial services 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 with respect to the ALL. Specifically –
  - The Firm selected for testing a control consisting of a review by the issuer's loan review group of a sample of loan grades assigned by the credit administration function; the loan grades were an

important factor in estimating the ALL. The Firm also selected a control that included management's review of the risk-assessment process for loans, including the determination of which loans would be subject to the first control. The Firm, however, failed to sufficiently test this latter control, as it failed to obtain an understanding of, and evaluate, the nature of the review procedures performed by the control owner. (AS No. 5, paragraphs 42 and 44)

- The Firm selected for testing three controls that consisted of management reviews of the ALL and related calculations. The Firm's testing of these controls was not sufficient, as follows –
  - The Firm's testing of two of these controls was limited to inquiring of the control owners and inspecting documentation used in the operation of these controls. The Firm failed to evaluate the expectations applied in the reviews, the criteria used to identify matters for follow up, and the resolution of such matters. (AS No. 5, paragraphs 42 and 44)
  - The Firm failed to test any controls that addressed the accuracy and completeness of the data used in the operation of the third control. (AS No. 5, paragraph 39)
- The issuer developed the qualitative component of the ALL, which represented a significant portion of the total ALL, by considering qualitative factors for each of its loan products and determining the amounts of the adjustments for these factors. The Firm failed to perform sufficient procedures to evaluate the reasonableness of these adjustments, as its procedures were limited to (1) obtaining an understanding of the factors used to develop the qualitative adjustments and (2) comparing certain data that the issuer used to determine the adjustments to data that the Firm obtained from external sources. In addition, the Firm identified certain economic trends that appeared to be inconsistent with the trends in the issuer's qualitative adjustments, but failed to perform procedures to investigate the apparent inconsistency and the potential effect on the ALL. Further, the Firm identified a fraud risk related to the



issuer's development of the qualitative adjustments due to the judgment involved, but the Firm failed to perform tests that were specifically responsive to this risk. (AS No. 13, paragraph 13; AS No. 14, paragraph 3; AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures to test the issuer's loan charge-offs, which were inputs to the calculation of the ALL. Specifically, the Firm failed to test the completeness of the population from which it selected its sample of transactions for testing. (AU 350, paragraph .24)
- The Firm failed to test the completeness of the data the issuer used in calculating the probability-of-default assumption; this assumption was a key input to the ALL calculation. (AU 342, paragraph .11)
- The Firm failed to sufficiently test the loss-emergence-period ("LEP") assumptions, which ranged from 0.6 to 4.5 years, and which were used in the ALL calculation. Specifically, the Firm limited its testing of the issuer's addition of six months to certain LEPs that had been calculated using historical data to inquiring of management, without obtaining corroboration of the explanations it received. (AU 342, paragraph .11)
- The Firm failed to perform sufficient procedures with respect to available-for-sale securities. Specifically –
  - The issuer recorded the fair values for available-for-sale securities based on the prices it received from an external pricing service. The Firm selected for testing a control that consisted of the issuer's comparison of the recorded fair values for a sample of available-for-sale securities to prices it received from other external parties. For items for which the control owner deemed the price differences to be significant, the issuer obtained and considered additional information from the external pricing service. The Firm failed to ascertain and evaluate the criteria the control owner used to identify differences as significant and the resolution of such differences. (AS No. 5, paragraphs 42 and 44)

- The Firm designed its substantive procedures – including sample sizes – to test the valuation and disclosure of certain available-for-sale securities based on a level of control reliance that was not supported due to the deficiency in the Firm's testing of the control that is discussed above. As a result, certain of the sample sizes that the Firm used in its testing of these available-for-sale securities were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.7. Issuer G

In this audit of an issuer in the financial services 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's procedures related to the ALL, for which it identified a fraud risk, were not sufficient. Specifically –
  - The Firm selected for testing a control that included management's review of the ALL. The Firm limited its procedures to test this control to inquiring of management, reading the issuer's policies, and inspecting documentation used in the operation of this control. The Firm failed to evaluate whether the control 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 owner, including the specific expectations applied in the review, the criteria used to identify items for follow up, and the resolution of such matters. (AS No. 5, paragraphs 42 and 44)
  - The Firm selected for testing controls consisting of (1) the review and approval of loan charge-offs, (2) the evaluation of loans that were identified as potentially impaired, and (3) the review of documentation of an external party's validation of models the issuer used to develop the assumptions underlying the quantitative component of the ALL. The Firm failed to identify and test any controls over the accuracy and completeness of certain important

data used in the operation of these controls. (AS No. 5, paragraph 39)

- The Firm failed to sufficiently test the operating effectiveness of a control that it selected for testing, which consisted of the updating and approval of loan data that the issuer used in the calculation of the ALL. Specifically, the Firm failed to test the completeness of the population from which it selected its sample of loans for testing this control. (AU 350, paragraph .39)
- The issuer developed the qualitative component of the ALL, which represented a significant portion of the total ALL, by considering certain reserve factors and developing weightings of those factors for each of its loan products. The Firm's procedures to test this component were limited to obtaining an understanding of the factors and weightings used in the development of this component and performing sensitivity analyses in which it determined the effects of certain changes in the amounts assigned to some of the factors and the resulting change in the qualitative component of the ALL. The Firm failed to evaluate whether the amounts assigned to the factors and weightings used in the development of this component were reasonable. In addition, the Firm failed to sufficiently test certain significant adjustments that the issuer made to the ALL calculation to account for imprecision in the model used in the calculation of the quantitative component of the ALL, as the Firm's procedures were limited to obtaining an understanding of the issuer's methodology and testing the mathematical accuracy of certain related calculations, without testing whether these adjustments were appropriate. (AU 342, paragraph .11)
- The Firm failed to test the accuracy and completeness of the loan charge-off data that the issuer used in the calculation of the quantitative component of the ALL. (AU 342, paragraph .11)
- The Firm failed to test the accuracy and completeness of the data that the issuer provided to the external party for use in validating the models that the issuer used to develop the assumptions

underlying the quantitative component of the ALL. (AU 342, paragraph .11)

- The Firm failed to sufficiently test ITGCs over user access to the issuer's ALL models. Specifically, the Firm failed to evaluate the appropriateness of the access of certain personnel who had administrator-level access both to ALL applications and to databases supporting the ALL calculation, even though the Firm had identified this access when testing user-access controls. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)
- The Firm failed to perform sufficient tests of controls over the valuation and disclosure of available-for-sale securities. The issuer recorded the fair values of available-for-sale securities based on the prices it received from an external pricing service. The Firm selected for testing a control that consisted of the review of a comparison, for a sample of available-for-sale securities, of the recorded amounts to prices that the issuer obtained from another external pricing service or to values produced by an internal cash flow model that the issuer used. In testing this control, the Firm evaluated the thresholds used by the issuer to identify outliers by comparing them to thresholds contained in internal Firm guidance. The Firm's evaluation was not sufficient, as (1) the Firm failed to take into account credit ratings and other characteristics of the issuer's available-for-sale securities when comparing the issuer's thresholds to thresholds contained in its internal guidance and (2) for certain available-for-sale securities, the Firm failed to evaluate whether the issuer's range of thresholds, which was wider than that developed by the Firm, was appropriate. In addition, the Firm failed to identify and test any controls that addressed whether the categorization of the securities within the fair value hierarchy as set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurement* was appropriate. (AS No. 5, paragraphs 39, 42, and 44)

#### A.8. Issuer H

In this audit of a retailer, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as the Firm failed to perform sufficient procedures to test controls over revenue. Specifically, the Firm failed

to identify and test any controls over the occurrence of revenue from credit and debit card transactions, which constituted approximately half of the issuer's revenue. (AS No. 5, paragraph 39)

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. The Firm's procedures related to the issuer's accounting for the business combination were insufficient in the following respects –

- The Firm selected for testing a control over the accounting for business combinations that included management's review of the cash-flow forecasts that were used to determine the fair value of the acquired intangible assets and the contingent consideration arrangements. The Firm's procedures to test this control were limited to obtaining the forecasts and inquiring of the control owner. The Firm failed to ascertain and evaluate the nature of the review procedures performed by the control owner, including (1) the basis for, and precision of, the control owner's expectations for the cash-flow forecasts and (2) the criteria the control owner used to identify items for follow up and how those items were resolved. As a result, the Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)
- The Firm failed to sufficiently evaluate the reasonableness of significant assumptions that the issuer used to determine the fair value of the acquired intangible assets and the contingent consideration arrangements. Specifically –
  - With respect to the revenue growth-rate assumption, the Firm's procedures were limited to inquiring of management and comparing the revenue projections to two external reports that it obtained from the issuer and that had been prepared for this acquisition; one report contained revenue growth rates for the acquired business and the other report contained revenue growth rates for the acquired business and other companies. The Firm failed to obtain

an understanding of the basis for the information in the external reports and whether the other companies included in one of the external reports were comparable to the acquired business. (AU 328, paragraphs .26, .28, and .31)

- For certain other significant assumptions, the Firm's procedures were limited to inquiring of management and management's external specialist. (AU 328, paragraphs .26 and .28)

A.10. Issuer J

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 Firm identified a fraud risk related to revenue. The Firm's testing of controls over revenue and accounts receivable was insufficient. Specifically –
  - For each of the issuer's two business units, the Firm selected for testing a control that consisted of management's approval of contract fee rates and terms. Neither of these controls, however, addressed the risks of incomplete or inaccurate entry of fee rates and terms into the issuer's systems, and the Firm failed to identify and test any other controls that addressed those risks. (AS No. 5, paragraph 39)
  - For revenue at one of the issuer's business units, the Firm selected for testing an automated application control that allowed only invoices marked as approved in the system to be processed. This control did not address whether the invoice had in fact been reviewed, and the Firm did not identify and test any controls that included the review and approval of the invoices. (AS No. 5, paragraph 39)
  - For revenue at the issuer's other business unit, the Firm selected a control that consisted of a review of reconciliations between the contract management system and the general ledger. The Firm,

however, failed to identify and test any controls over the accuracy and completeness of the report generated by the contract management system that the control owners used in the operation of this control. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test revenue, deferred revenue, accounts receivable, and accrued revenue. The Firm designed its substantive procedures – including 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, certain of the sample sizes that the Firm used in its testing were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.11. Issuer K

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- The Firm failed to perform sufficient testing of net sales and accounts receivable at certain of the issuer's locations, which in the aggregate represented over 35 percent of consolidated net sales and accounts receivable. These aggregate amounts were multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement. To test net sales and accounts receivable at these locations, the Firm limited its procedures to obtaining and testing the mathematical accuracy of certain management reports that included comparisons of financial statement accounts to those in prior periods, inquiring about certain account fluctuations identified in such reports, reading sales contracts, and comparing the aging of the accounts receivable to the aging in the prior year. The Firm failed to (1) sufficiently test whether the accounts receivable existed, as its procedures were limited to inquiring about changes in the aging of accounts receivable, and (2) test whether the recognized revenue appropriately reflected the contract terms. (AS No. 9, paragraphs 11 and 12)

- The Firm failed to perform sufficient substantive testing of inventories at the issuer's locations described above, which in the aggregate represented over 30 percent of total inventories. This aggregate amount was multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement. To test these inventories, however, the Firm limited its procedures to obtaining and testing the mathematical accuracy of the management reports described above and inquiring about certain account fluctuations identified in such reports. (AS No. 9, paragraphs 11 and 12)

A.12. Issuer L

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 Firm designated certain of the issuer's locations, which represented a significant portion of total revenue and accounts receivable, as limited-scope locations. The Firm tested certain entity-level controls at these locations. These controls consisted of monthly meetings to review recorded results compared to prior periods and to discuss key performance indicators ("KPIs"). The Firm's procedures to test these controls were insufficient, as its testing was limited to (1) inquiring of the control owners, (2) obtaining meeting materials and noting items discussed, and (3) noting evidence that all critical KPIs were discussed and that significant fluctuations were explained. The Firm failed to evaluate the nature of the procedures performed by the control owners, including the criteria used by the control owners to identify matters for investigation and the appropriateness of the resolution of such matters. (AS No. 5, paragraphs 42 and 44)
- The Firm failed to perform sufficient substantive procedures to test revenue and accounts receivable. Based in part on its reliance on the entity-level controls, the testing of which is described above, the Firm inappropriately reduced its substantive testing of the existence and valuation of revenue and accounts receivable so as not to perform any



procedures at the limited-scope locations described above. (AS No. 9, paragraphs 11 and 12)

A.13. Issuer M

The Firm was engaged by the principal auditor of an issuer to audit the financial statements and the effectiveness of ICFR of a wholly owned subsidiary to support the principal auditor's opinions on the consolidated financial statements and ICFR. The Firm failed to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audits, as the Firm's testing related to certain revenue, which represented the majority of the subsidiary's total revenue, was insufficient. Specifically –

- The issuer's accounting policy was to recognize revenue upon delivery of its products to its customers. The issuer recorded revenue when products were shipped and then recorded period-end adjustments to reverse revenue for shipped products that had not been delivered to customers by the end of the period. The Firm identified a fraud risk related to these adjustments. The Firm identified and tested three controls to address this risk; these controls consisted of (1) an automated control configured to generate invoices upon shipment confirmation, (2) an automated control configured to obtain electronic payments from customers when delivery information or certain other information was received or time had passed, and (3) management's review and authorization of journal entries prior to posting. The Firm, however, failed to test the aspects of these controls related to whether revenue from the products shipped but not delivered to customers was appropriately reversed. (AS No. 5, paragraphs 42 and 44)
- The Firm's primary substantive procedures to test this revenue consisted of analytical procedures. The Firm used data related to the products that had been shipped but not delivered as of the period end in its analytical procedures. The Firm failed to sufficiently test controls over these data as discussed above or otherwise test the completeness of these data. (AU 329, paragraph .16)

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 effectiveness of

ICFR. Specifically, the Firm's procedures related to the qualitative component of the ALL, which represented a significant portion of the total ALL, and for which the Firm identified a fraud risk, were not sufficient. The Firm selected for testing a control that consisted of a committee's review of the ALL calculation, including the factors used to determine the qualitative component. The Firm's procedures to test this control were limited to inquiring of the control owners and reading the committee's meeting minutes. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain and evaluate the nature of the specific review procedures performed, including the expectations applied in the review of the ALL calculation, the criteria to identify matters for follow up, and the resolution of those matters. In addition, the Firm identified and tested three controls to address the accuracy and completeness of data used in the operation of this control. In assessing whether these controls achieved this objective, however, the Firm failed to consider that the control owners performing the controls' reviews and reconciliations of the data also had unrestricted access to all of the data and related calculations. (AS No. 5, paragraphs 42 and 44)

A.15. Issuer O

In this audit of a mutual fund, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements. Specifically –

- The issuer used a service organization to perform accounting and custodial functions. The Firm obtained the service auditor's reports, which specified necessary user controls. The Firm identified certain of the user controls that it considered applicable to the issuer; however, the Firm did not test the design and operating effectiveness of these user controls. The Firm also cited other controls that it believed met the same objectives as the user controls, but failed to test them. The Firm designed its procedures to test investment income and purchases and sales of investments – including its sample sizes – based on a level of control reliance that was not supported due to this deficiency. As a result, the sample sizes the Firm used in its tests of these accounts were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 324, paragraphs .13 and .14; AU 350, paragraphs .19, .23, and .23A)

- To test the accuracy of the issuer's accounting records for purchases and sales of investments, the Firm compared a sample of transactions selected from the issuer's accounting records to information in another system that was used to maintain trade records, but it failed to perform procedures to test the accuracy of the information in this other system. (AS No. 15, paragraph 10)
- The Firm failed to sufficiently test the issuer's disclosure of investments in the fair value hierarchy set forth in FASB ASC 820. Specifically, the Firm, in selecting a sample size, failed to consider all relevant factors, and the sample used to test investments was too small to provide sufficient evidence. (AU 350, paragraphs .23 and .23A)

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 a result of a business combination during the year, the issuer acquired significant intangible assets. The Firm selected for testing a control over the accounting for business combinations that included management's review of the forecast that the issuer used in determining the fair value of the acquired intangible assets. The Firm's testing of this control was not sufficient. Specifically, the Firm limited its procedures to inquiring of management, inspecting certain documentation used in the operation of the control, and obtaining an email that indicated that the control owner had approved the forecast. The Firm failed to evaluate whether the control 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 owner, including the expectations applied in the review of the forecast described above, the criteria used to identify matters for follow up, and the resolution of such matters. (AS No. 5, paragraphs 42 and 44)

A.17. Issuer Q

In this audit of an issuer in the health care industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing a control over revenue that consisted of management's review of monthly reports related to price changes. The design of this control required the control owner to select at least one of each type of price change and compare each selected change to supporting documentation. The Firm's testing of

this control was not sufficient. Specifically, the Firm's procedures were limited to (1) inquiring of the control owner, (2) inspecting the reports and observing signatures as evidence of review, and (3) comparing a sample of the items reviewed by the control owner to supporting documentation. The Firm failed to evaluate how the control owner determined that all types of changes were included in the items selected for review. (AS No. 5, paragraph 44)

A.18. Issuer R

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements. For a significant portion of the issuer's business, the Firm assessed control risk as high for revenue. The Firm's procedures to test this revenue consisted of (1) substantive analytical procedures, using revenue data disaggregated by quarter and using a threshold to identify differences for investigation that was the same as the Firm's established annual level of tolerable misstatement for the business component that generated this revenue; and (2) tests of a small number of transactions in conjunction with the testing of accounts receivable balances outstanding at year end. Given the Firm's assessment of control risk as high, and the fact that the analytical procedures were the Firm's primary test of this revenue, the Firm's threshold used to identify differences for investigation for each quarter was too high to provide sufficient evidence. (AU 329, paragraph .20)

A.19. Issuer S

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as the Firm failed to perform sufficient procedures to test controls over the period-end financial reporting process related to the statement of cash flows. The Firm selected for testing a control over the statement of cash flows that consisted of management's quarterly reviews of the financial statements, including the statement of cash flows, and the related supporting documentation. The Firm, however, failed to sufficiently test this control. Specifically, the Firm's procedures were limited to (1) obtaining the supporting documentation and noting signatures as evidence that the reviews had occurred and (2) comparing one financial statement note disclosure reviewed by management to the supporting documentation. The Firm failed to evaluate 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 performed, including the criteria used by

the control owner to identify matters for follow up and the resolution of such matters. (AS No. 5, paragraphs 26, 42, and 44)

A.20. Issuer T

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 effectiveness of ICFR, as its procedures related to the issuer's ALL were not sufficient. Specifically, the Firm selected for testing a control that consisted of a review, by a group independent of the loan management function, of the assigned loan grades for certain loans; the loan grades were an important factor in estimating the ALL. The Firm tested this control on an interim basis for the first eight months of the year. The Firm's procedures to update this interim testing to the year end were limited to inquiring of the control owner and obtaining reports prepared by the control owner that described only the results of the reviews and certain data regarding the outstanding loans, without the analysis applied to the individual loans reviewed. These roll-forward procedures were not sufficient given the Firm's assessment of this control as having a higher risk of failure and the length of the roll-forward period. (AS No. 5, paragraphs 55 and 56)

**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> | Issuer A      | 3                                       |
|   | Issuer B      | 4                                       |
|   | Issuer C      | 5                                       |
|   | Issuer D      | 1                                       |
|   | Issuer E      | 4                                       |
|   | Issuer F      | 4                                       |
|   | Issuer G      | 4                                       |
|   | Issuer H      | 1                                       |
|   | Issuer I      | 1                                       |
|   | Issuer J      | 3                                       |

| PCAOB Auditing Standards  | Audits   | Number of Deficiencies per Audit |
|---|--|----------------------------------|
|   | Issuer L<br>Issuer M<br>Issuer N<br>Issuer P<br>Issuer Q<br>Issuer S<br>Issuer T | 1<br>1<br>1<br>1<br>1<br>1<br>1  |
| AS No. 9, <i>Audit Planning</i>   | Issuer A<br>Issuer B<br>Issuer D<br>Issuer K<br>Issuer L                         | 1<br>1<br>1<br>2<br>1            |
| AS No. 13, <i>The Auditor's Responses to the Risks of Material Misstatement</i> | Issuer A<br>Issuer B<br>Issuer D<br>Issuer F<br>Issuer J<br>Issuer O             | 1<br>1<br>1<br>2<br>1<br>1       |
| AS No. 14, <i>Evaluating Audit Results</i>                                      | Issuer C<br>Issuer F   | 1<br>1                           |
| AS No. 15, <i>Audit Evidence</i>  | Issuer B<br>Issuer G<br>Issuer O   | 1<br>1<br>1                      |
| AU 324, <i>Service Organizations</i>  | Issuer O   | 1                                |
| AU 328, <i>Auditing Fair Value Measurements and Disclosures</i>                 | Issuer B<br>Issuer C<br>Issuer I   | 1<br>1<br>2                      |





|   | AS<br>No.<br>5                     | AS<br>No.<br>9      | AS<br>No.<br>13 | AS<br>No.<br>14 | AS<br>No.<br>15 | AU<br>324 | AU<br>328 | AU<br>329 | AU<br>342 | AU<br>350     |
|---|------------------------------------|---------------------|-----------------|-----------------|-----------------|-----------|-----------|-----------|-----------|---------------|
| Income taxes  | A                                  |                     |                 |                 |                 |           |           |           | A         |               |
| Inventory   | A, D                               | A, D,<br>K          | A, D            |                 |                 |           |           |           |           | A, D          |
| Securitized   | C                                  |                     |                 | C               |                 |           |           |           |           | C             |
| Investments, including derivatives                          | C, F,<br>G                         |                     | F, O            |                 | O               | O         | C         |           |           | F, O          |
| Revenue, including accounts receivable and deferred revenue | A, B,<br>D,<br>H, J,<br>L, M,<br>Q | A, B,<br>D, K,<br>L | A, B,<br>D, J   |                 | B               |           |           | M, R      |           | A, B,<br>D, J |

### B.3. Audit Deficiencies by Industry

The table below lists the industries<sup>3</sup> of the issuers for which audit deficiencies were discussed in Part I.A of this report and cross references the issuers to the specific auditing standards related to the deficiencies.<sup>4</sup>

|                        | AS<br>No.<br>5 | AS<br>No.<br>9 | AS<br>No.<br>13 | AS<br>No.<br>14 | AS<br>No.<br>15 | AU<br>324 | AU<br>328 | AU<br>329 | AU<br>342  | AU<br>350     |
|------------------------|----------------|----------------|-----------------|-----------------|-----------------|-----------|-----------|-----------|------------|---------------|
| Consumer Discretionary | B, H,<br>M     | B              | B               |                 | B               |           | B         | M         |            | B             |
| Financial Services     | C, E,<br>F, G, |                | F, O            | C, F            | G,<br>O         | O         | C         | R         | E, F,<br>G | C, F,<br>G, O |

<sup>3</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>4</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.

|                        | AS<br>No.<br>5 | AS<br>No.<br>9 | AS<br>No.<br>13 | AS<br>No.<br>14 | AS<br>No.<br>15 | AU<br>324 | AU<br>328 | AU<br>329 | AU<br>342 | AU<br>350 |
|------------------------|----------------|----------------|-----------------|-----------------|-----------------|-----------|-----------|-----------|-----------|-----------|
|                        | N, S,<br>T     |                |                 |                 |                 |           |           |           |           |           |
| Health Care            | I, J,<br>Q     |                | J               |                 |                 |           | I         |           |           | J         |
| Industrials            | D, L           | D, L           | D               |                 |                 |           |           |           |           | D         |
| Information Technology | A, P           | A              | A               |                 |                 |           |           |           | A         | A         |
| Materials              |                | K              |                 |                 |                 |           |           |           |           |           |

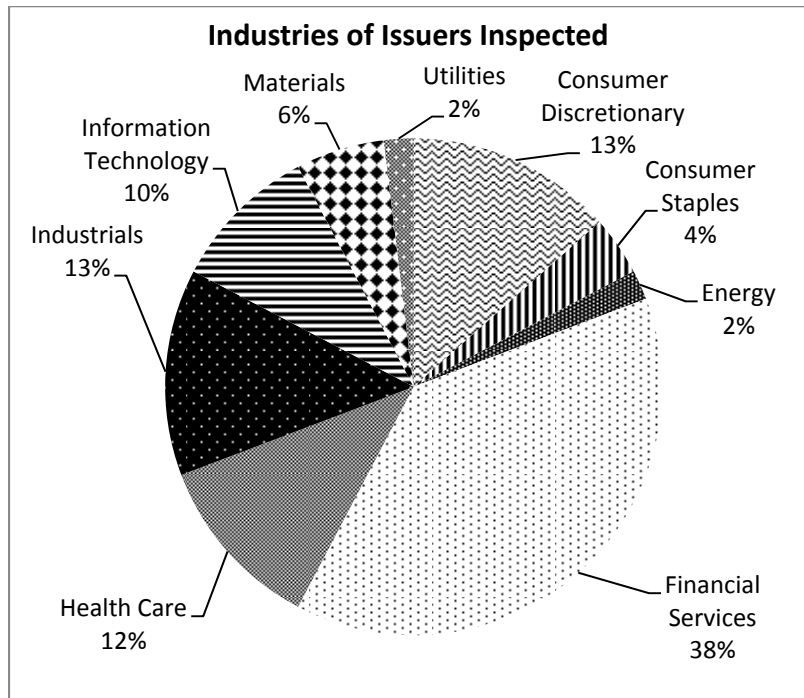
**C. Data Related to the Issuer Audits Selected for Inspection<sup>5</sup>**

C.1. Industries of Issuers Inspected

The chart below categorizes the 52 issuers whose audits were inspected in 2015, based on the issuer's industry.<sup>6</sup>

<sup>5</sup> Where the audit work inspected related to an engagement in which the Firm played a role but was not the principal auditor, the industry and the revenue included in the tables and charts in this section are those of the entity for which an audit report was issued by the primary auditor. As discussed above, the inspection process included reviews of portions of 49 selected issuer audits completed by the Firm and the Firm's audit work on three other issuer audit engagements in which it played a role but was not the principal auditor.

<sup>6</sup> See Footnote 3 for additional information on how industry sectors were classified.

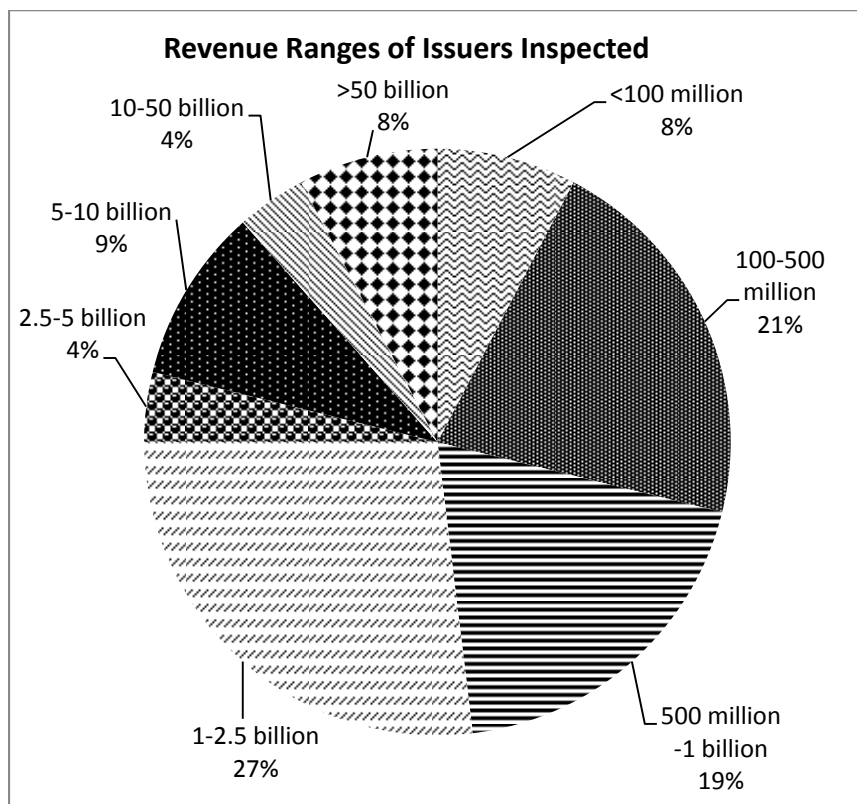


| Industry               | Number of Audits Inspected | Percentage |
|------------------------|----------------------------|------------|
| Consumer Discretionary | 7                          | 13%        |
| Consumer Staples       | 2                          | 4%         |
| Energy                 | 1                          | 2%         |
| Financial Services     | 20                         | 38%        |
| Health Care            | 6                          | 12%        |
| Industrials            | 7                          | 13%        |
| Information Technology | 5                          | 10%        |
| Materials              | 3                          | 6%         |
| Utilities              | 1                          | 2%         |

## C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 52 issuers whose audits were inspected in 2015.<sup>7</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>7</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.



| Revenue (in US\$)      | Number of Audits inspected | Percentage |
|------------------------|----------------------------|------------|
| <100 million           | 4                          | 8%         |
| 100-500 million        | 11                         | 21%        |
| 500 million -1 billion | 10                         | 19%        |
| 1-2.5 billion          | 14                         | 27%        |
| 2.5-5 billion          | 2                          | 4%         |
| 5-10 billion           | 5                          | 9%         |
| 10-50 billion          | 2                          | 4%         |
| >50 billion            | 4                          | 8%         |

**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>8</sup> as well as a 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.

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<sup>8</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 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.

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.

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>9</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

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

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 assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion or a failure to obtain sufficient appropriate audit evidence to fulfill the objectives of the firm's role in an audit may indicate a defect or potential defect in a firm's quality control system.<sup>10</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

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<sup>10</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.

considers the nature, significance, and frequency of deficiencies;<sup>11</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 (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

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<sup>11</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.



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



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PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED  
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## PART II

### ISSUES RELATED TO QUALITY CONTROLS

This Part II contains a discussion of criticisms of and potential defects in the Firm's quality control system.<sup>12</sup> As described below, an analysis of the inspection results reported by the inspection team, including the results of the reviews of individual audits, \* \* \* \* indicates that the Firm's system of quality control requires remedial action in order to provide sufficient assurance that the Firm's audit work will meet applicable standards and requirements.

#### **Deficiencies in the System of Quality Control Related to Testing Internal Control**

Under PCAOB quality control standards, a firm should have policies and procedures that provide it with reasonable assurance that work is assigned to personnel who have the necessary degree of technical proficiency (QC 20, paragraph .13) and that the work performed by those personnel meets applicable professional standards (QC 20, paragraphs .03 and .17). The inspection results indicate that the Firm's system of quality control does not provide such assurance with respect to testing and evaluating internal control in accordance with AS No. 5 and AS No. 13.<sup>13</sup>

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<sup>12</sup> This report's description of quality control issues is based on the inspection team's observations during the primary inspection procedures. Any changes or improvements that the Firm may have made in its system of quality control since that time \* \* \* \* [have been] taken into account by the Board during its assessment of whether the Firm has satisfactorily addressed the quality control criticisms or defects within the twelve months after the issuance of this report.

<sup>13</sup> As noted within this section, issues related to compliance with AS No. 7, paragraphs 9 and 10; AS No. 10, paragraphs 5 and 6; AS No. 13, paragraph 7; and AU 230, paragraphs .07 and .08, appear to have been among the potential causes of some of the identified deficiencies.

In 16 audits,<sup>14</sup> all of which are included in Part I.A of this report, the Firm failed to sufficiently test and/or evaluate internal control, in that the Firm's procedures were deficient in one or more of the following areas: (1) selecting controls that address risks of material misstatement to the relevant assertions, [and] (2) testing the design and operating effectiveness of controls \* \* \* \*. Deficiencies related to testing internal control were also identified in prior years.

While the number of audits with identified deficiencies related to testing internal control declined as compared to the 2014 inspection,<sup>15</sup> the rate of audits that were identified with deficiencies in this area remains high and is of concern, not only due to the severity and recurring nature of the deficiencies, but also because of the pervasive effect of internal control on the overall audit.

Deficiencies Related to Selecting Controls that Address Risks of Material Misstatement to the Relevant Assertions

The Firm failed to identify and select for testing controls that sufficiently addressed the assessed risks of material misstatement to the relevant assertions in five audits.<sup>16</sup> In two of these audits,<sup>17</sup> the failure occurred in an area where the Firm had identified a fraud risk.

Deficiencies Related to Testing the Design and Operating Effectiveness of Controls

The inspection team identified deficiencies related to testing the design and/or operating effectiveness of controls that the Firm had selected for testing in

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<sup>14</sup> Issuers A, B, C, D, E, F, G, H, I, J, L, M, N, P, Q, and S

<sup>15</sup> In 2014, the inspection team identified deficiencies related to testing internal control in 28 audits, 27 of which were included in Part I.A of that report.

<sup>16</sup> Issuers A, C, G, H, and J

<sup>17</sup> Issuers C and J

14 audits,<sup>18</sup> all of which are included in Part I.A of this report. In four of these 14 audits,<sup>19</sup> the deficiencies involved the Firm's testing of controls that the Firm had identified as addressing fraud risks.

In 13 of these 14 audits,<sup>20</sup> all of which are included in Part I.A of this report, the Firm failed to evaluate whether the controls it had selected operated at a level of precision to prevent or detect material misstatements. These deficiencies included failures to ascertain and/or evaluate the nature of the review procedures performed by the control owners and failures to evaluate (1) the expectations applied in the reviews, (2) the criteria used to identify matters for follow up, and (3) the resolution of such matters.

In three of these 13 audits,<sup>21</sup> the issuer had operations in multiple locations. At certain locations, which either individually, or when aggregated, presented a reasonable possibility of material misstatement to the issuer's financial statements, the Firm's testing of controls over revenue and certain other significant accounts consisted of testing certain entity-level controls. The Firm, however, failed to appropriately evaluate whether the entity-level controls selected for testing operated at a sufficient level of precision to address the risks of material misstatement to the relevant assertions.

In eight of these 14 audits,<sup>22</sup> the Firm failed to test, or to sufficiently test, controls over the accuracy and completeness of data or reports used in the operation of the controls that the Firm tested.

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<sup>18</sup> Issuers A, B, C, D, E, F, G, I, L, M, N, P, Q, and S

<sup>19</sup> Issuers E, F, G, and M

<sup>20</sup> Issuers A, B, C, D, E, F, G, I, L, N, P, Q, and S

<sup>21</sup> Issuers B, D, and L

<sup>22</sup> Issuers B, C, D, E, F, G, J, and N

The deficiencies indicate that some of the Firm's professionals are not performing the procedures to identify and test controls with sufficient rigor, and appropriate members of the engagement teams may not be devoting sufficient attention to supervising, including reviewing, these procedures. Certain deficiencies also suggest that some engagement quality control review ("EQCR") partners did not perform their reviews as thoroughly as necessary or devote sufficient time and attention to their reviews. In addition, certain of the deficiencies described above may be due to some of the Firm's professionals lacking a sufficient understanding of PCAOB standards in this area. Further, the inspection results indicate that some of the Firm's professionals do not have a sufficient understanding either of the need to exercise professional skepticism when testing and evaluating controls, or of how to apply professional skepticism in those circumstances. For example, certain engagement teams placed too much reliance on inquiry when testing controls with a review element \* \* \* \*.

The Firm has recently identified potential root causes of certain historical deficiencies in testing and evaluating internal control; these causes relate to time compression and the lack of effective project management, including the sequencing of the audit process by engagement teams. In response to these causes, the Firm began an initiative in 2015, "Accelerating Audit Execution," designed to assist engagement teams in effectively managing the sequencing and performance of audit procedures. Further, during May 2015, the Firm issued guidance requiring engagement teams to select and prepare flowcharts for at least two of the issuers' core processes in audits of issuers conducted in 2016 and 2017 and to select and prepare flowcharts for all core processes in audits of issuers beginning in 2018. In addition, the Firm implemented a pre-issuance monitoring program to evaluate engagement teams' approaches to selecting and testing controls and an audit quality support program whereby assigned coaches will provide direct audit support to a small number of selected engagement teams.

The Firm should evaluate the effectiveness of these actions in addressing the concerns noted above and develop and implement any further remedial actions that are necessary. In addition to its monitoring activities, the Firm should continue to perform its analyses of potential root causes of the deficiencies in these areas. These analyses should include consideration of whether the Firm's professionals have a sufficient understanding of PCAOB standards in these areas and whether engagement team leadership is providing appropriate supervision, and EQCR partners are performing appropriate review, of tests of controls. The analyses should also specifically address whether additional guidance or training, enhancements to communications, or other



changes to the Firm's system of quality control are necessary to provide reasonable assurance that the Firm's professionals will appropriately select, test, and evaluate controls. As a result of its analyses, the Firm should develop and implement appropriate remedial actions as necessary.

**Deficiencies in the System of Quality Control Related to Testing [the ALL]\*\*\*\***

The inspection results indicate that the Firm's system of quality control does not provide the reasonable assurance described in QC 20, paragraphs .03 and .17, that the work performed by the Firm's personnel with respect to testing \* \* \* \* the ALL, will meet the requirements of AS No. 14, \* \* \* \* and AU 342.<sup>23</sup> \* \* \* \*

The deficiencies related to testing [the ALL] \* \* \* \* are a source of concern, not only due to their frequency and recurring nature, but also because the development of [the ALL]\* \* \* \* can involve management's most complex and subjective judgments, and thus this area often involves enhanced risks. Effective testing of [the ALL] \* \* \* \* requires the application of professional skepticism and often requires the involvement of, and appropriate supervision by, the most senior members of the engagement team.

The deficiencies indicate that some of the Firm's professionals may lack a sufficient understanding of how to apply PCAOB standards in this area. The deficiencies may also be caused by a failure by some of the Firm's professionals to appropriately apply professional skepticism, sometimes by accepting management's views based on confidence in management's expertise and in other cases simply by failing to approach the auditing of [the ALL] \* \* \* \* with sufficient rigor. For example, some engagement teams did not sufficiently challenge management's judgments and assumptions, such as in situations where the Firm identified information that was potentially inconsistent with the issuer's approach or assumptions. In addition, the deficiencies suggest that the senior members of certain of the Firm's engagement teams did not appropriately supervise, including by reviewing, the work performed in these important areas of the

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<sup>23</sup> As noted within this section, issues related to compliance with AS No. 7, paragraphs 9 and 10; AS No. 10, paragraphs 5 and 6; AS No. 13, paragraph 7; and AU 230, paragraphs .07 and .08, appear to have been among the potential causes of some of the identified deficiencies.

audit. These deficiencies also suggest that some EQCR partners did not perform their reviews as thoroughly as necessary or devote sufficient time and attention to their reviews.

In 2015, the inspection team identified the deficiencies in the Firm's substantive testing of [the ALL] \* \* \* \* that are described below.

\* \* \* \*

The inspection results indicate deficiencies in the Firm's system of quality control with respect to testing the ALL. The inspection team reviewed the Firm's auditing of the ALL in 11 audits and identified deficiencies in the substantive testing in three of these audits,<sup>24</sup> each of which is included in Part I.A of this report. In each of these audits, the Firm failed to sufficiently evaluate the reasonableness of the assumptions related to the qualitative component of the ALL, and in two of these audits,<sup>25</sup> the Firm also failed to sufficiently evaluate certain other significant assumptions that management used in developing the ALL. In two of these three audits,<sup>26</sup> the Firm determined that the issuer's assumptions or conclusions were reasonable without evaluating, or without sufficiently evaluating, all of the relevant evidence regardless of whether it appeared to corroborate or to contradict those assumptions or conclusions. Further, in two of these three audits,<sup>27</sup> the Firm failed to test, or to sufficiently test, the accuracy and completeness of certain data that management used to develop the ALL.

While the 2015 inspection results indicate a continued trend of improvement, the deficiencies identified in the Firm's auditing of the ALL during

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<sup>24</sup> Issuers E, F, and G

<sup>25</sup> Issuers F and G

<sup>26</sup> Issuers E and F

<sup>27</sup> Issuers F and G

2015 are similar to those identified in prior Board inspections.<sup>28</sup> In October 2015, the Firm implemented a new pre-issuance review program<sup>29</sup> for the majority of its issuer bank audits. This program included the establishment of a framework for the Firm to evaluate each of the selected engagement teams' risk assessment and analysis of the issuer's ALL methodology and the team's plans for, and execution of, the evaluation of management's judgments and assumptions used to determine the ALL. The Firm should assess the results of these reviews as part of its evaluation of whether further actions are necessary with respect to the Firm's auditing of the ALL.

\* \* \* \*

The Firm should continue to perform its analysis of potential root causes of the deficiencies in this area, which should include evaluating whether its professionals have an appropriate understanding of how to apply PCAOB standards when testing \* \* \* \* the ALL. The analysis should also assess why certain professionals apparently failed to (1) evaluate the reasonableness of significant underlying assumptions with the necessary professional skepticism and (2) adequately supervise or review the work performed in this area. As a result of this analysis, the Firm should develop and implement any additional remedial actions that are needed.

### **Deficiencies in the System of Quality Control Related to the Application of Professional Skepticism**

The inspection results indicate that the Firm's system of quality control does not provide the reasonable assurance described in QC 20, paragraphs .03 and .17, that the Firm's personnel will appropriately exercise the professional skepticism required by AS No. 13, AS No. 14, and AU 230 in the performance of issuer audits. The application of professional skepticism is essential to the performance of effective audits under PCAOB standards, and a lack of professional skepticism can have a pervasive effect on an

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<sup>28</sup> Part I.A deficiencies were observed in seven of 12 audits in which the ALL was reviewed in 2014, and nine \* \* \* \* such audits in 2013.

<sup>29</sup> These are reviews that are performed before the issuance of the Firm's audit report.

audit. Audit deficiencies related to the failure to appropriately apply professional skepticism were also identified in \* \* \* \* the 2014 inspection.

In 2015, the inspection team identified deficiencies in 15 audits,<sup>30</sup> 14 of which are described in Part I.A of this report,<sup>31</sup> that appear to be caused, at least in part, by the failure to appropriately exercise professional skepticism. Most of these deficiencies occurred when the Firm limited its procedures to, or relied heavily on, inquiring of management and reading issuer-prepared analyses or documentation that summarized transactions, procedures, or methods. In 10 of these audits,<sup>32</sup> the Firm's failure to appropriately exercise professional skepticism occurred in areas where it had identified a significant risk, including a fraud risk in some instances. Further, in three of these 15 audits,<sup>33</sup> the Firm determined that the issuer's assumptions or conclusions were reasonable without evaluating, or without sufficiently evaluating, all of the relevant evidence regardless of whether it appeared to corroborate or to contradict those assumptions or conclusions.

Certain of these deficiencies may be due to some of the Firm's professionals lacking a sufficient understanding of the need to exercise professional skepticism and how to do so, or a lack of sufficient emphasis and specificity on this point in the Firm's guidance and training. For example, in many instances, the Firm's professionals did not appear to understand how to apply professional skepticism when testing controls; in some instances, the Firm's procedures were limited to simply determining that the control operated, that relevant documentation was prepared, and that data used in the control tied to the issuer's systems, without performing an appropriate critical assessment of the effectiveness of the control. In addition, some deficiencies may stem, in part, from engagement teams seeking to gather and evaluate information that is consistent with management's judgments or representations, without critically

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<sup>30</sup> Issuers A, B, C, D, E, F, G, I, J, M, N, P, Q, S, and U

<sup>31</sup> Issuers A, B, C, D, E, F, G, I, J, M, N, P, Q, and S

<sup>32</sup> Issuers A, C, E, F, G, I, M, N, Q, and S

<sup>33</sup> Issuers E, F, and J

assessing all of the relevant audit evidence, possibly due to concerns unrelated to the objective of performing a quality audit.

The Firm has identified causes of certain historical deficiencies in this area that include the Firm's professionals having placed a level of reliance on past experiences with the issuer, or on issuer-prepared documentation, that was inappropriate under the circumstances. Also, the Firm has observed that reviews by managers and partners that are too late in the process and that reviews that are performed off-site may be affecting the application of professional skepticism. In response to these causes, the Firm began the Accelerating Audit Execution initiative, implemented a new pre-issuance review program for the majority of its issuer bank audits, and issued additional guidance to assist engagement teams with testing estimates other than the ALL.

The Firm should evaluate the effectiveness of these actions in addressing the concerns noted above and develop and implement any further remedial actions that are necessary. In addition to its monitoring activities, the Firm should continue to take steps to provide that its professionals have a sufficient understanding of how to appropriately apply professional skepticism, including by performing a critical assessment of the effectiveness of the controls they test and of the evidence they obtain through their substantive procedures. The Firm should also take steps to provide that its professionals perform procedures to address identified fraud risks and sufficiently evaluate all of the relevant audit evidence, including evidence that may appear to contradict or be inconsistent with management's judgments or representations. Further, the Firm should continue to consider the effectiveness of supervisory and review procedures performed related to areas involving judgment.

In addition, the Firm should continue to perform its analyses of the potential root causes of the deficiencies in this area, including its efforts to identify incidents in which its professionals failed to appropriately apply professional skepticism. As a result of these analyses, the Firm should develop and implement additional remedial actions.

#### **Deficiencies in the Firm's [Pre-issuance Review] \* \* \* \* Programs**

Under PCAOB quality control standards, a firm's system of quality control should include policies and procedures that provide the firm with reasonable assurance that the firm's policies and procedures related to the other elements of quality control are suitably designed and are being effectively applied (QC 20, paragraph .20). The

inspection results indicate that the Firm's system of quality control related to monitoring audit quality does not provide such assurance. \* \* \* \*

The Firm's procedures related to monitoring include the Firm's \* \* \* \* pre-issuance review programs. \* \* \* \* The pre-issuance review programs include the review of pre-determined areas of certain audits to enhance the quality of the audit work, if needed, and to assess both the quality of audit work and the effectiveness of certain of the Firm's remedial actions. The PCAOB inspection results provide cause for concern about the effectiveness of \* \* \* \* the \* \* \* \* pre-issuance review programs.

\* \* \* \*

During 2015, the PCAOB inspection team inspected 13 audits<sup>34</sup> that had also been reviewed through the Firm's pre-issuance review programs. In four of these audits,<sup>35</sup> the PCAOB inspection team identified at least one Part I.A audit deficiency that the Firm's pre-issuance reviews had not detected, even though the pre-issuance reviewer had reviewed the same area. These results suggest that the pre-issuance review programs are not operating effectively enough to achieve their objectives.

The inspection results may be due to pre-issuance reviewers evaluating the audit work performed based on an inadequate understanding of the application of PCAOB standards and Firm guidance, in some cases applying a similar inappropriate interpretation as that of the engagement team whose work they are reviewing.

The Firm has recently identified possible causes of historical weaknesses in certain of the pre-issuance review programs. The identified causes include inappropriate or inadequate staffing, including using EQCR partners to perform both the EQCR and pre-issuance reviews on the same engagements, who, by virtue of their role as EQCR partner would not provide the desired second review. In response, during the second half of 2015, the Firm implemented a plan that includes (1) eliminating the use of EQCR partners in these monitoring

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<sup>34</sup> Issuers B, G, L, N, T, W, X, Y, Z, AA, BB, CC, and DD

<sup>35</sup> Issuers B, G, N, and T

roles, (2) refining the reviewer-assignment process to better match reviewers' industry experience and availability with the audits they are assigned to review, and (3) increasing the use of full-time [Quality Performance Review] ["QPR"] reviewers in these reviews. The Firm should continue to evaluate whether the complement of reviewers is appropriate to drive consistent and effective execution of these reviews.

The Firm also should evaluate the effectiveness of the changes it has made to these monitoring programs \* \* \* \*. This analysis should include consideration of whether the Firm's reviewers have a sufficient understanding of PCAOB standards. As a result of this analysis, the Firm should develop and implement any additional remedial actions that are necessary.

### **Deficiencies in the System of Quality Control Related to Engagement Supervision and Review**

The inspection results indicate that the Firm's system of quality control does not provide the reasonable assurance described in QC 20, paragraphs .03 and .17, and QC 40, paragraph .08, that the supervisory, including review, activities performed by the Firm's partners will meet the requirements of AS No. 10 and that the review activities performed by the EQCR partners will meet the requirements of AS No. 7.<sup>36</sup>

\* \* \* \* [M]any of the deficiencies that the inspection team identified appear to have been the result, at least in part, of inadequate reviews of the audit work by the engagement partner and/or the EQCR partner.

#### Engagement Partner Supervision, Including Review

The 2015 inspection results show deficiencies in the supervision of audits, including review of audit work, by the Firm's engagement partners. In 15 audits,<sup>37</sup>

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<sup>36</sup> As noted within this section, issues related to compliance with AS No. 13, paragraph 7, and AU 230, paragraphs .07 and .08, appear to have been among the potential causes of some of the identified deficiencies.

<sup>37</sup> Issuers A, B, C, D, E, F, G, I, J, M, N, P, R, T, and U

including 14 audits described in Part I.A of this report,<sup>38</sup> the inspection team identified deficiencies in an area for which the Firm's guidance appears to have required the engagement partner to perform a review of the relevant audit documentation, but the engagement partner failed to identify and appropriately address the deficiencies. In 11 of these 15 audits,<sup>39</sup> including 10 audits described in Part I.A of this report,<sup>40</sup> the engagement team had identified a significant risk for the area in which the deficiency was identified, including a fraud risk in some instances.

These deficiencies suggest that some engagement partners may not have a sufficient understanding of applicable PCAOB standards to assess the audit work in order to fulfill their supervisory responsibilities. In addition, these deficiencies suggest that some engagement partners may not be approaching their reviews of the audit work with the professional skepticism necessary to assess whether sufficient appropriate audit evidence has been obtained. Further, these deficiencies indicate that certain engagement partners did not perform their reviews as thoroughly as necessary or devote sufficient time and attention to their reviews.

#### Engagement Quality Review

The 2015 inspection results show deficiencies in the Firm's engagement quality reviews. In 11 of the 15 audits discussed above,<sup>41</sup> 10 of which are included in Part I.A of this report,<sup>42</sup> the inspection team identified a deficiency in an area that was or should have been subject to the EQCR partner's evaluation.

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<sup>38</sup> Issuers A, B, C, D, E, F, G, I, J, M, N, P, R, and T

<sup>39</sup> Issuers A, C, E, F, G, I, J, M, N, T, and U

<sup>40</sup> Issuers A, C, E, F, G, I, J, M, N, and T

<sup>41</sup> Issuers A, B, D, E, F, G, I, M, N, T, and U

<sup>42</sup> Issuers A, B, D, E, F, G, I, M, N, and T



For example, in nine of these 11 audits,<sup>43</sup> including eight audits described in Part I.A of this report,<sup>44</sup> the EQCR partner failed to identify or appropriately address a deficiency in an area of significant risk, including in some cases a fraud risk. Also, in two of these 11 audits, both included in Part I.A of this report,<sup>45</sup> the EQCR partner failed to appropriately evaluate the significant judgments made by the engagement team about the severity and effect of control deficiencies.

These deficiencies suggest that some EQCR partners may not have a sufficient understanding of applicable PCAOB standards to assess the work in order to fulfill their review responsibilities, did not perform their reviews as thoroughly as necessary, or did not devote sufficient time and attention to their reviews.

The Firm has recently identified potential root causes of certain historical deficiencies in these areas. The causes identified included (1) time compression and the lack of effective project management, including the sequencing of the audit process by engagement teams, and (2) excessive workloads. In response to these causes, the Firm began its Accelerating Audit Execution initiative in an effort to provide for, among other things, a timely review of the audit documentation by engagement partners and EQCR partners. Further, during October 2015, the Firm revised its guidance to require engagement partners to review certain additional audit documentation.

The Firm should evaluate the effectiveness of these actions in addressing the concerns noted above, including the causes that the Firm has identified. The Firm also should continue to perform its analyses of potential root causes of the deficiencies in these areas, and it should implement additional corrective actions as necessary.

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<sup>43</sup> Issuers A, E, F, G, I, M, N, T, and U

<sup>44</sup> Issuers A, E, F, G, I, M, N, and T

<sup>45</sup> Issuers A and E

## **Deficiencies in the System of Quality Control Related to the Partner Evaluation Process**

Under PCAOB quality control standards, a firm should have policies and procedures to provide the firm with reasonable assurance that \* \* \* \* partners have the required competencies \* \* \* \* and that responsibility for the design and maintenance of the quality control system be assigned to appropriate individuals (QC 20, paragraphs .13, .21, and .22; QC 30, paragraph .03 \* \* \* \*). The inspection results indicate that the Firm's system of quality control does not provide the necessary reasonable assurance that the Firm will comply with applicable quality control standards related to the evaluation of partners \* \* \* \* in the following respects –

\* \* \* \*

### Accountability of Other Partners Involved in Issuer Audits

As part of its partner evaluation process, the Firm requires consideration of whether [negative audit quality incidents] [("]NAQIs[")]) related to issuer audits should be attributed to [Business Unit Professional Practice Partners] [("]BUPPPs[")]), [Regional Professional Practice Partners] [("]RPPPs[")]), and industry and national office leaders who were involved with the relevant issuer audit. For its 2014 and 2015 fiscal years, the Firm determined that none of the hundreds of NAQIs that had been identified were attributable to any BUPPP, RPPP, or industry and national office leader. The Firm did not document a rationale to support its determination regarding any of these individuals with respect to any of the NAQIs.

The Firm's messaging indicates that audit quality is of critical importance. The circumstances described above, however, provide cause for concern that the Firm may not have implemented sufficient appropriate mechanisms to address indicators of deficiencies in audit quality of all those with authority over, and involvement in, the conduct of audits. A result of these circumstances could be that BUPPPs, RPPPs, and industry and national office leaders who were involved with relevant issuer audits may not consider audit quality to be of the critical importance that the Firm accords it in its overall messaging, and a matter for which they will be held accountable when appropriate.

\* \* \* \* [T]he Firm should evaluate whether the partner evaluation process adequately addresses whether partners beyond those on the engagement team are held accountable, when appropriate, for NAQIs on audits with respect to which they have some involvement. As a result of its evaluation, the Firm should develop and implement appropriate remedial actions to address the concerns in this area.

\* \* \* \*

**PCAOB Standards and Rules**

The table below lists the specific PCAOB standards that are primarily related to the descriptions of defects in, or criticisms of, the Firm's system of quality control included in this Part of the report.<sup>46</sup>

| <b>PCAOB Standards and Rules</b>  |
|---|
| <i>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i> |
| <i>AS No. 7, Engagement Quality Review</i>  |
| <i>AS No. 10, Supervision of the Audit Engagement</i>   |
| * * * *   |
| <i>AS No. 13, The Auditor's Responses to the Risks of Material Misstatement</i>   |
| <i>AS No. 14, Evaluating Audit Results</i>  |
| * * * *   |
| <i>AU 230, Due Professional Care in the Performance of Work</i>   |
| * * * *   |
| <i>AU 342, Auditing Accounting Estimates</i>  |

<sup>46</sup> This table does not necessarily include reference to every standard that may have been related to the criticisms or potential defects that are included in Part II.

| <b>PCAOB Standards and Rules</b>   |
|--|
| <i>QC 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>  |
| <i>QC 30, Monitoring a CPA Firm's Accounting and Auditing Practice</i>   |
| <i>QC 40, The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement</i> |

\* \* \* \*

## **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>47</sup>

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<sup>47</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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October 28, 2016

Ms. Helen A. Munter  
Director - Division of Registration and Inspections  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, DC 20006-2803

Re: Response to Part I of Draft Report on the 2015 Inspection of KPMG LLP

Dear Ms. Munter:

We are pleased to provide our response to Part I of the Public Company Accounting Oversight Board's ("PCAOB") Draft Report on 2015 Inspection of KPMG LLP dated September 27, 2016 ("Draft Report").

We take the findings from the PCAOB inspection process seriously and believe the inspection process serves to assist us in identifying areas where we can continue to improve our performance and strengthen our system of audit quality control. We remain committed to full cooperation with the PCAOB, appreciate the professionalism and commitment of the PCAOB staff and value the important role the PCAOB plays in improving audit quality.

We conducted a thorough evaluation of the matters identified in Part I of the Draft Report and have taken appropriate actions to address the engagement-specific findings in a manner consistent with PCAOB auditing standards and KPMG policies and procedures.

Consistently executing high-quality audits is our top priority. We remain dedicated to continuous improvement in our audit engagement performance and our system of audit quality control, including monitoring audit quality and implementing changes to our policies and practices in order to enhance audit quality. We understand our responsibility to investors and other participants in the capital markets and are committed to continuing to work constructively with the PCAOB to improve audit quality and build confidence in the auditing profession.

Sincerely yours,

KPMG LLP

Lynne M. Doughtie  
*Chairman and Chief Executive Officer*

Scott M. Marcello  
*Vice Chair – Audit*

**APPENDIX C**

**AUDITING STANDARDS REFERENCED IN PART I.A**

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. 5.26   | <p><i>Period-end Financial Reporting Process.</i> Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following -</p> <ul style="list-style-type: none"> <li>▪ Procedures used to enter transaction totals into the general ledger;</li> <li>▪ Procedures related to the selection and application of accounting policies;</li> <li>▪ Procedures used to initiate, authorize, record, and process journal entries in the general ledger;</li> <li>▪ Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and</li> <li>▪ Procedures for preparing annual and quarterly financial statements and related disclosures.</li> </ul> <p>Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.</p> | Issuer S |
| <b>Identifying Significant Accounts and Disclosures and Their Relevant Assertions</b>   |  |          |

**AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements**

|   |   |          |
|---|---|----------|
| AS No. 5.29   | <p>To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include -</p> <ul style="list-style-type: none"> <li>▪ Size and composition of the account;</li> <li>▪ Susceptibility to misstatement due to errors or fraud;</li> <li>▪ Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;</li> <li>▪ Nature of the account or disclosure;</li> <li>▪ Accounting and reporting complexities associated with the account or disclosure;</li> <li>▪ Exposure to losses in the account;</li> <li>▪ Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;</li> <li>▪ Existence of related party transactions in the account; and</li> <li>▪ Changes from the prior period in account or disclosure characteristics.</li> </ul> | Issuer C |
| <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 implemented to address these potential misstatements; and</li> <li>• Identify the controls that management has implemented over the prevention or timely</li> </ul>   | Issuer C |



| <b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b> |   |  |
|---|---|--|
|   | detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.  |  |
| <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, F, G, H, and J                |
| <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, G, I, L, M, N, P, and S    |
| <b>Testing Operating Effectiveness</b>  |   |  |
| AS No. 5.44   | <p>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.</p> <p>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</p>   | Issuers A, B, C, D, E, F, G, I, L, M, N, P, Q, and S |

| <b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</b> |   |          |
|---|---|----------|
|   | <p>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.</p>   |          |
| <b>Relationship of Risk to the Evidence to be Obtained</b>  |   |          |
| AS No. 5.46   | <p>For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases</p> <p>Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.</p> | Issuer B |
| AS No. 5.47   | <p>Factors that affect the risk associated with a control include –</p> <ul style="list-style-type: none"> <li>• The nature and materiality of misstatements that the control is intended to prevent or detect;</li> <li>• The inherent risk associated with the related account(s) and assertion(s);</li> <li>• Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;</li> <li>• Whether the account has a history of errors;</li> <li>• The effectiveness of entity-level controls, especially controls that monitor other</li> </ul>  | Issuer B |

**AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements**

|             |  |          |
|-------------|--|----------|
|             | <p>controls;</p> <ul style="list-style-type: none"> <li>• The nature of the control and the frequency with which it operates;</li> <li>• The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);</li> <li>• The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;</li> <li>• Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and</li> </ul> <p>Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.</p> <ul style="list-style-type: none"> <li>• The complexity of the control and the significance of the judgments that must be made in connection with its operation.</li> </ul> <p>Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.</p> |          |
| AS No. 5.48 | When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the  | 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>evidence to be obtained, as well as on the operating effectiveness of the control.</p> <p>Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.</p>   |          |
| AS No. 5.55   | <p><i>Roll-Forward Procedures.</i> When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.</p>   | Issuer T |
| AS No. 5.56   | <p>The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors -</p> <ul style="list-style-type: none"> <li>▪ The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;</li> <li>▪ The sufficiency of the evidence of effectiveness obtained at an interim date;</li> <li>▪ The length of the remaining period; and</li> <li>▪ The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.</li> </ul> <p>Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.</p> | Issuer T |
| <b>EVALUATING IDENTIFIED DEFICIENCIES</b>   |   |          |
| AS No. 5.62   | <p>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.</p>  | Issuer E |

| <b>AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</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 misstatement to the company's consolidated financial statements.</p> | Issuers A and B |

| <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 | Issuers A, B, D, K, and L |

|                                 |  |                           |
|---------------------------------|--|---------------------------|
| <b>AS No. 9, Audit Planning</b> |  |                           |
|                                 | business unit with the degree of risk of material misstatement associated with that location or business unit.   |                           |
| <u>Footnote to AS No. 9.11</u>  |  |                           |
|                                 | <sup>13/</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.   |                           |
| AS No. 9.12                     | <p>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 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</li> </ul> | Issuers A, B, D, K, and L |

| <b>AS No. 9, Audit Planning</b> |  |  |
|---------------------------------|--|--|
|                                 | <p>monitoring activities by the company or others at the location or business unit.</p> <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>  |  |
| <u>Footnotes to AS No. 9.12</u> |  |  |
|                                 | <p><sup>14/</sup> Paragraph .66 of AU sec. 316, <i>Consideration of Fraud in a Financial Statement Audit</i>.</p> <p><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.</p> <p><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.</p> <p><sup>17/</sup> Paragraphs B10-B16 of Auditing Standard No. 5.</p> |  |

| <b>AS No. 13, The Auditor's Responses to the Risks of Material Misstatement</b> |  |                              |
|---|--|------------------------------|
| <b>RESPONSES TO FRAUD RISKS</b>   |  |                              |
| AS No. 13.13  | <p><i>Addressing Fraud Risks in the Audit of Financial Statements.</i> In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.</p> | Issuer F                     |
| <b>Testing Controls</b>   |  |                              |
| <b>TESTING CONTROLS IN AN AUDIT OF FINANCIAL STATEMENTS</b>                     |  |                              |
| AS No. 13.16  | <p><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</p>   | Issuers A, B, D, F, J, and O |

| <b>AS No. 13, The Auditor's Responses to the Risks of Material Misstatement</b>  |  |                              |
|--|--|------------------------------|
|  | 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.   |                              |
| <u>Footnotes to AS No. 13.16</u>   |  |                              |
| <p><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.</p> <p><sup>13/</sup> Terms defined in Appendix A, <i>Definitions</i>, are set in <b>boldface type</b> the first time they appear.</p> |  |                              |
| AS No. 13.18   | <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. | Issuers A, B, D, F, J, and O |
| <b>Substantive Procedures</b>  |  |                              |
| AS No. 13.37   | 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.   | Issuers A, B, D, F, J, and O |



| <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.  | Issuer F |
| <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 Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.</p> | Issuer C |

| <b>AS No. 15, <i>Audit Evidence</i></b>          |  |                   |
|--|--|-------------------|
| <b>Sufficient Appropriate Audit Evidence</b>     |  |                   |
| <b>USING INFORMATION PRODUCED BY THE COMPANY</b> |  |                   |
| AS No. 15.10                                     | When using information produced by the company | Issuers B, G, and |

| <b>AS No. 15, Audit Evidence</b>   |   |   |
|--|---|---|
|  | <p>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> | O |
| <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 324, Service Organizations</b>   |  |          |
|--|--|----------|
| <b>The User Auditor's Consideration of the Effect of the Service Organization on the User Organization's Internal Control and the Availability of Audit Evidence</b> |  |          |
| <b>Assessing Control Risk at the User Organization</b>   |  |          |
| AU 324.13  | <p>The user organization may establish effective controls over the service organization's activities that may be tested and that may enable the user auditor to reduce the assessed level of control risk below the maximum for some or all of the related assertions. If a user organization, for example, uses a service organization to process its payroll transactions, the user organization may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. The user organization might reperform the service organization's payroll calculations on a test basis. In this situation, the user auditor may perform tests of the user organization's controls over payroll processing that would provide a basis for assessing control risk below the maximum for the assertions related to payroll transactions. Alternatively, the user auditor may decide to assess control risk at the maximum level because he or she believes</p> | Issuer O |

| <b>AU 324, Service Organizations</b>   |   |          |
|--|---|----------|
|  | controls are unlikely to pertain to an assertion, are unlikely to be effective, or because he or she believes obtaining evidence about the operating effectiveness of the service organization's controls, such as those over changes in payroll programs, would not be efficient. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]  |          |
| AU 324.14  | The user auditor may find that controls relevant to assessing control risk below the maximum for particular assertions are applied only at the service organization. If the user auditor plans to assess control risk below the maximum for those assertions, he or she should evaluate the operating effectiveness of those controls by obtaining a service auditor's report that describes the results of the service auditor's tests of those controls (that is, a report on controls placed in operation and tests of operating effectiveness, or an agreed-upon procedures report) <sup>fn 2</sup> or by performing tests of controls at the service organization. If the user auditor decides to use a service auditor's report, the user auditor should consider the extent of the evidence provided by the report about the effectiveness of controls intended to prevent or detect material misstatements in the particular assertions. The user auditor remains responsible for evaluating the evidence presented by the service auditor and for determining its effect on the assessment of control risk at the user organization. | Issuer O |
| Footnote to AU 324.14  |   |          |
| <p><sup>fn 2</sup> See AT section 201, <i>Agreed-Upon Procedures Engagements</i>, for guidance on performing and reporting on agreed-upon procedures engagements. [Footnote added, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.].</p> |   |          |

| <b>AU 328, Auditing Fair Value Measurements and Disclosures</b>                                   |   |                 |
|---|---|-----------------|
| <b>Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data</b> |   |                 |
| AU 328.26   | 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 | Issuers B and I |

| <b>AU 328, Auditing Fair Value Measurements and Disclosures</b>               |  |                 |
|---|--|-----------------|
|   | <p>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>   |                 |
| AU 328.28   | 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.  | Issuers B and I |
| AU 328.31   | 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.  | Issuer I        |
| AU 328.39   | The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, the auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency, including whether such information is consistent with management's intent and ability to carry out specific courses of action discussed in paragraph .17. | Issuer B        |
| <b>Developing Independent Fair Value Estimates for Corroborative Purposes</b> |  |                 |
| <b>Disclosures About Fair Values</b>  |  |                 |

| <b>AU 328, Auditing Fair Value Measurements and Disclosures</b>  |  |          |
|--|--|----------|
| 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 C |
| <p><u>Footnote to AU 328.43</u></p> <p><sup>fn 8</sup> See also paragraph 31 of Auditing Standard No. 14, <i>Evaluating Audit Results</i>.</p> |  |          |

| <b>AU 329, Substantive Analytical Procedures</b>       |  |          |
|--|--|----------|
| <b>Analytical Procedures Used as Substantive Tests</b> |  |          |
| <b>Availability and Reliability of Data</b>            |  |          |
| AU 329.16  | <p>Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:</p> <ul style="list-style-type: none"> <li>• Whether the data was obtained from independent sources outside the entity or from sources within the entity</li> <li>• Whether sources within the entity were independent of those who are responsible for the</li> </ul> | Issuer M |

| <b>AU 329, Substantive Analytical Procedures</b>               |   |          |
|--|---|----------|
|  | <p>amount being audited</p> <ul style="list-style-type: none"> <li>• Whether the data was developed under a reliable system with adequate controls</li> <li>• Whether the data was subjected to audit testing in the current or prior year</li> <li>• Whether the expectations were developed using data from a variety of sources</li> </ul>   |          |
| <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 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.</p> | Issuer R |

| <b>AU 342, Auditing 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> <ol 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, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.</li> </ol> | Issuers E, F, and G |

| <b>AU 342, Auditing Accounting Estimates</b> |   |          |
|--|---|----------|
|  | <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> |          |
| AU 342.12                                    | Develop an expectation. Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.  | Issuer A |

| <b>AU 350, Audit Sampling</b>                   |  |                              |
|---|--|------------------------------|
| <b>Sampling In Substantive Tests Of Details</b> |  |                              |
| AU 350.19                                       | 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 | Issuers A, B, D, F, J, and O |

| <b>AU 350, Audit Sampling</b>   |   |                              |
|---|---|------------------------------|
|   | <p>procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases 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.</p> |                              |
| <p><b>Footnote to AU 350.19</b></p> <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   | <p>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.</p>  | Issuers A, B, D, F, J, and O |
| AU 350.23A  | <p>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.</p>   | Issuers A, B, D, F, J, and O |
| <b>Sample Selection</b>   |   |                              |
| AU 350.24   | <p>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, haphazard and random-based selection of items</p>   | Issuers C and F              |



|                                      |  |          |
|--------------------------------------|--|----------|
| <b>AU 350, Audit Sampling</b>        |  |          |
|                                      | represents two means of obtaining such samples. <sup>fn 4</sup>  |          |
| <u>Footnote to AU 350.24</u>         |  |          |
|                                      | <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>Sample Selection</b>              |  |          |
| AU 350.39                            | 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. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit. Paragraphs 44 through 46 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end. | Issuer G |

**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 reorganization of the 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 324  | <i>Service Organizations</i>  | AS 2601                                    | <i>Consideration of an Entity's Use of a Service Organization</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 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>                    |