PCAOB
Public Company Accounting Oversight Board

1666 K Street NW
Washington, DC 20006
Office: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

Report on

2017 Inspection of BDO USA, LLP
(Headquartered in Chicago, IL)

Issued by the

Public Company Accounting Oversight Board

June 20, 2019

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

PORTIONS OF THE COMPLETE REPORT ARE OMITTED FROM THIS DOCUMENT IN ORDER TO COMPLY WITH SECTIONS 104(g)(2) AND 105(b)(5)(A) OF THE SARBANES-OXLEY ACT OF 2002

PCAOB RELEASE NO. 104-2019-085

2017 INSPECTION OF BDO USA, LLP

TABLE OF CONTENTS FOR PART I OF THE INSPECTION REPORT

EXECUTIVE SUMMARY

In 2017, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm BDO USA, LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act"). The inspection procedures included reviews of portions of the Firm's work on 23 issuer audits, which generally related to issuer year ends in 2016.

The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. In nine audits, certain of these deficiencies 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. These deficiencies are described in Part I.A of the report.

The Board cautions against using the number of audits with deficiencies in the public portion of a report to draw conclusions about the frequency of deficiencies throughout the firm's practice. The audits to be reviewed are most often selected based on perceived risk and not through a process designed to identify a representative sample that could be extrapolated to the firm's entire practice. The portions of these audits that are reviewed often involve the most risky areas of the financial statements. Thus, much of the audit work that is inspected presents, in the inspection team's view, a heightened possibility of auditing deficiencies.

In the 2017 inspection, the inspection team also assessed the Firm's system of quality control related to issuer audits. Pursuant to the Act, any criticisms or discussions of defects or potential defects in that system will remain nonpublic unless the Firm fails to address those criticisms or defects to the Board's satisfaction no later than 12 months after the issuance of this report.

Audit Opinions Affected by the Identified Deficiencies

Twenty of the 23 engagements inspected were integrated audits of both internal control and the financial statements. As depicted in the table below, the inspection team identified deficiencies in both financial statement audits and audits of internal control over financial reporting ("ICFR"). Two of the deficiencies described in Part I.A of this report relate to auditing an aspect of an issuer's financial statements that the issuer restated after the primary inspection procedures.[1] In two of the audits described below,

[1] The 2017 inspection did not include review of any additional audit work related to the restatements.

after the primary inspection procedures, the Firm revised its opinions on the effectiveness of the issuer's ICFR to express adverse opinions.

	Number of Audits
Audits for which deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	7 Audits: Issuers A, B, C, D, E, F, and G
Audits for which deficiencies included in Part I.A related to the ICFR audit only	1 Audit: Issuer H
Audits for which deficiencies included in Part I.A related to the financial statement audit only	1 Audit: Issuer I
Total	9

Most Frequently Identified Audit Deficiencies

The following table lists, in summary form, the types of deficiencies that appear most frequently in Part I.A of this report and shows which issuer audits included these deficiencies.

Issue	Part I.A Audits
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing	7 Audits: Issuers A, B, C, D, E, G, and H
Failure to sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate	5 Audits: Issuers A, B, C, D, and E
Failure to identify and test any controls that addressed the risks related to a particular account or assertion	4 Audits: A, B, D, and G

Areas in which Audit Deficiencies Were Most Frequently Identified

The following table lists, in summary form, the financial statement accounts or auditing areas in which the deficiencies that are included in Part I.A of this report most frequently occurred.

Area	Part I.A Audits
Revenue, including accounts receivable and deferred revenue	3 Audits: Issuers A, H, and I
Business combinations	2 Audits: Issuers A and D

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Inspections are designed and performed to assess compliance with applicable standards and requirements. The inspection team reviews both (1) selected audits and (2) policies and procedures related to quality control processes. The primary procedures[2] for the inspection were performed from July 2017 to May 2018. Inspectors conducted field work at the Firm's National Office and inspected issuer audits performed by 13 of the Firm's approximately 42 U.S. practice offices.[3]

Part I.A includes a description of all audit deficiencies that reach a defined level of significance, which is described below. These deficiencies are categorized in various ways in both Part I.B and the Executive Summary. Part I.C of this report provides certain demographic information about all of the audits inspected. Part I.D provides a general description of the procedures performed in an annual inspection.

Inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control. This focus on deficiencies and defects necessarily carries through to inspection reports and, therefore, the reports are not intended as balanced report cards or overall rating tools. Further, the lack of discussion within a report of an aspect of the inspected firm's quality control system should not be interpreted to imply that the Board has reached a conclusion about that aspect. Similarly, 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, an 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 described in that report.

---

[2] 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.

[3] This represents the Firm's total number of practice offices; however, approximately 40 of the Firm's practice offices have primary responsibility for issuer audit clients.

The inspection team's evaluation of the Firm's quality control system included both (1) a review of certain aspects of the Firm's quality control system and (2) an assessment of whether the deficiencies identified in individual audits indicate defects or potential defects in the Firm's system of quality control.

A. Review of Audit Engagements

The inspection procedures included reviews of portions of 23 issuer audits performed by the Firm.

Certain of the deficiencies were of such significance that the inspection team determined that the Firm issued an opinion without obtaining sufficient appropriate audit evidence that the financial statements were free of material misstatement and/or the issuer maintained effective ICFR. These deficiencies are described in Part I.A. The descriptions in Part I.A include references to the auditing standards that most directly relate to those deficiencies. (See Appendix C for the text of these standards.) References to provisions of the auditing standards that generally address all aspects of the audit are provided only when lack of compliance with these standards is the primary reason for the deficiency.[4]

Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. In many cases, the Firm has since performed remedial actions intended to address the deficiencies.[5] That an audit deficiency reached the level of significance to be included in Part I.A of an inspection report does not mean that the financial statements are misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team to reach a conclusion on those points because the inspection team usually has

---

[4] These broadly applicable provisions are described in Part I.B of this report.

[5] 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. An inspection normally includes a review, on a sample basis, 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 could be a basis for criticisms of the firm's quality control system or Board disciplinary sanctions.

only the information the auditor retained and the issuer's public disclosures. Even when not associated with a disclosed misstatement or previously unidentified material weakness, an auditor's failure to obtain sufficient appropriate audit evidence is a serious matter.

The audit deficiencies that were so significant that it appeared that the audit opinion was unsupported are described in Parts I.A.1 through I.A.9, below. Issuer audits are generally presented in the order of significance of the deficiencies identified in the inspections of those audits; severity is assessed based on extent of the deficiencies identified in the audit, financial statement accounts affected, and/or potential consequences of the audit deficiency.

Audit Deficiencies

A.1. <u>Issuer A</u>

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer recognized revenue using the completed-contract and percentage-of-completion ("POC") methods, and also on a services-performed basis ("service basis"). The Firm failed in the following respects to perform sufficient procedures related to revenue recognized under each of these methods –

- With respect to certain of the issuer's revenue, the Firm failed to identify, and evaluate the significance to the financial statements of, a departure from generally accepted accounting principles ("GAAP"). (AS 2810.30)

- The Firm failed to perform sufficient procedures related to certain revenue recognized using the completed-contract method, as follows –

  - The Firm failed to identify and test any controls over the evaluation of whether revenue transactions accounted for as bill-and-hold arrangements met certain of the criteria for such accounting treatment. (AS 2201.39)

  - The issuer initially recorded all invoices as deferred revenue and adjusted this balance at month end to recognize revenue from contracts that were completed during the month. The Firm failed to identify and test any controls over the appropriateness of these adjustments. (AS 2201.39)

  - The Firm determined its sample size for testing revenue recognized using the completed-contract method based on the assurance it had obtained from other substantive procedures. These other procedures consisted of testing (1) a sample of accounts receivable at year end and (2) revenue cut-off at year end for a very small number of transactions at two of the issuer's 20 locations. As these procedures were performed at year end, they provided only limited assurance over this revenue for the full year and, as a result, the sample that the Firm used to test revenue that was recognized throughout the year using the completed-contract method was too small to provide sufficient evidence. (AS 2315.19, .23, and .23A)

- The Firm failed to perform sufficient procedures related to revenue recognized using the POC method, for which the Firm identified a fraud risk related to the estimated costs to complete open contracts, as follows –

  - The Firm selected for testing a control that included the review of POC calculations, including the estimated costs to complete. The Firm's procedures to test this aspect of the control were limited to inquiring of one of the preparers of the POC calculations and inspecting documents with notations and signatures that indicated reviews had occurred. The Firm failed to ascertain and evaluate the nature of the procedures that the control owner performed to review the estimated costs to complete, including the criteria the control owner used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

  - The Firm's substantive procedures to test the estimated costs to complete open contracts were limited to (1) tracing estimated costs to complete from the POC schedules to the issuer's initial project budgets for a sample of contracts, (2) comparing the gross margin percentages for certain contracts that were completed at year end to the prior year's estimated gross margin percentages for these contracts to evaluate the issuer's ability to estimate gross margins, and (3) comparing gross margin percentages at the end of the fourth quarter to those at the end of the third quarter of the current year. While these procedures provided the Firm with certain evidence related to open contracts and trends in recorded margins, they only provided limited evidence related to the reasonableness of the estimated costs to complete open contracts and the Firm did not perform any other procedures to evaluate the reasonableness of these estimates. (AS 2501.11)

- The Firm failed to perform sufficient procedures related to revenue recognized using the service basis, as follows –

  - The Firm selected a control that consisted of the review and approval of customers' orders. The Firm failed to sufficiently test this control, as it failed to evaluate whether the control owner's review included determining whether the requirements under GAAP that there was persuasive evidence of an arrangement and that the price was fixed and determinable for the transactions that were recorded were met, and the Firm failed to identify and test any other controls that did so. (AS 2201.42 and .44)

  - The Firm determined its sample size for testing revenue recognized using the service basis method based on the assurance it had obtained from other substantive procedures. These other procedures consisted of testing (1) a sample of accounts receivable at year end and (2) revenue cut-off at year end for three of the issuer's 44 locations. As these procedures were performed at year end, they provided only limited assurance over this revenue for the full year and, as a result, the sample that the Firm used to test service basis revenue that was recognized throughout the year was too small to provide sufficient evidence. (AS 2315.19, .23, and .23A)

- The Firm designed certain of its substantive procedures to test completed-contract revenue, service basis revenue, and certain related accounts receivable – including the sample sizes used in those procedures – 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 that the Firm used in these tests were too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

- The issuer acquired a business during the year. Revenue generated by the acquired business was multiple times the Firm's established level of materiality. The Firm designed certain of its substantive procedures to test this revenue – including its sample size – based on a level of control reliance that was not supported because the acquired business was excluded from the ICFR audit, and the Firm did not perform any other tests of controls over this revenue. As a result, the sample the Firm used to test this revenue was too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

A.2. Issuer B

In this audit of an issuer in the financials industry sector, 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 allowance for loan losses ("ALL"), as follows –
  - The issuer assigned loan grades to each loan. The loan grades were an important factor in estimating the ALL. The Firm's procedures to test the loan grades were insufficient in the following respects –
    - The Firm selected for testing a control related to loan grades that consisted of the review of the assigned loan grades for loans that met certain criteria and the approval of the loan grade by a committee. To test this control, the Firm selected a sample of reviewed loans, traced certain information to the underlying loan files, and read the committee's meeting minutes. The Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately resolved. In addition, in performing its substantive procedures, the Firm failed to evaluate whether the factors and assumptions that the issuer used to assign the loan grades were reasonable. (AS 2201.42 and .44; AS 2501.11)
    - With respect to the loans that were not subject to the control described above, which represented approximately 70 percent of the issuer's total loans, the Firm failed to identify and test any controls over the issuer's risk assessment

process to address the risk of inappropriate loan grades. (AS 2201.39)

- The Firm selected a sample of loans to substantively test the reasonableness of the issuer's loan grades assigned to each loan. For each loan in this sample, the Firm's procedures were limited to tracing certain information from the loan file to the general ledger, inspecting the borrower's financial data, and reading the loan file for impairment indicators. The Firm failed to evaluate whether the factors and assumptions that the issuer used to assign the loan grades were reasonable. (AS 2501.11)

- The Firm designed certain of its substantive procedures – including the sample size used in those procedures – 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 that the Firm used to test the loan grades was too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

o The issuer estimated the general reserve component of the ALL using a model that consisted of historical loss and qualitative components. The significant assumptions used to determine the historical loss component included the look-back period and the loss-emergence period. The issuer developed the qualitative component of the ALL, which represented a significant portion of the total ALL, by applying certain factors ("qualitative loss factors") to each loan type. The Firm's procedures related to the general reserve were insufficient, as follows –

- The Firm selected for testing two controls that consisted of (1) the review and approval of the qualitative loss factors and (2) the review and approval of the ALL, including the look-back period, loss-emergence period, and changes in the qualitative factors. The Firm's procedures to test these controls consisted of (1) inquiring of the control owners; (2) reading the issuer's memorandum and supporting schedules; (3) tracing certain information from the memorandum and supporting schedules to source documents, prior-year calculations, or the general ledger; and (4) inspecting evidence that a review had occurred. The Firm failed to evaluate the nature of the review procedures that the control owners performed, including the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain loan data the issuer used in determining the general reserve. (AS 2201.39, .42, and .44)

        - The Firm's substantive procedures to test the qualitative loss factors consisted of (1) reading the issuer's memorandum, (2) performing inquiries, (3) tracing certain data in the memorandum to internal and external sources and supporting calculations, (4) evaluating trends in qualitative factors, and (5) testing the mathematical accuracy of the calculation of the general reserve. The Firm, however, failed to evaluate the appropriateness of the qualitative factors used in the issuer's model and the amount of the resulting reserve. In addition, the Firm failed to test the accuracy and completeness of certain loan data the issuer used in determining the general reserve, as described above, or to test the accuracy and completeness of these data. (AS 2501.11)

- The Firm failed to perform sufficient procedures related to available-for-sale ("AFS") securities. Specifically –

    - The issuer determined the fair values of the AFS securities using one of the following two methods: (1) obtaining prices from an external pricing service or (2) averaging non-binding price quotes from brokers, depending on the type of security. The Firm's testing of controls over the valuation of these securities was insufficient in the following respects –

        - The Firm selected for testing a control that consisted of the review and resolution of pricing differences, which met certain criteria, between the prices provided by the external pricing service and prices the issuer obtained from an external valuation specialist. No pricing differences met the issuer's criteria for investigation. To test this control, the Firm established its own criteria for investigation and investigated pricing differences that met its criteria. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy of the pricing data the issuer used in the performance of this control. (AS 2201.39 and .42)

        - The Firm failed to identify and test any controls over the valuation of securities priced using broker quotes. (AS 2201.39)

    - To address the presentation and disclosure of the AFS securities, the Firm selected for testing a control that consisted of the review of the categorization of AFS securities by Level within the hierarchy set forth in FASB ASC Topic 820, *Fair Value Measurement*. The Firm's procedures to test this control were limited to inquiring of management and reading the issuer's fair value memorandum. The Firm failed to evaluate whether the control was designed to operate at a level of precision that would prevent or detect material misstatements, given that the control was designed to review securities aggregated by security type and did not include consideration of whether the securities aggregated within each security type were valued using different inputs. In addition, the Firm failed to evaluate whether the control took into consideration the issuer's practice of averaging non-binding broker quotes to value certain securities in its determination of the Level within the hierarchy set forth in FASB ASC Topic 820. (AS 2201.42)

- The issuer used cash-flow forecasts to determine the fair value of debentures. The Firm selected for testing a control over the valuation of the debentures that consisted of the reviews of the cash-flow forecasts and memorandum. The Firm's procedures to test this control were limited to reading the memorandum, inquiring of one of the preparers, and tracing the fair values to the general ledger. The Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

A.3. Issuer C

In this audit of an issuer that provides insurance services and is in the financials industry sector, 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, as it failed to sufficiently test the loss reserves, for which it identified a fraud risk. Specifically –

- The Firm selected for testing five controls that consisted of (1) the reviews of the analyses of risk transfer for new and renewed contracts, (2) the review of the loss development factors used to calculate the loss reserves, (3) the review of the minutes of meetings held by the issuer's actuarial group to discuss the loss reserves, (4) the review by the issuer's Reserve Committee of the loss reserves, and (5) the review of an external actuarial report. The Firm's procedures were insufficient, as follows –

    - The Firm's procedures to test these controls consisted of inquiring of certain of the control owners, reading supporting documentation and/or meeting minutes, and inspecting evidence that the reviews had occurred. The Firm failed to evaluate the nature of the specific review procedures that the various control owners performed, including the criteria used by those control owners to identify matters for follow up and whether those matters were appropriately resolved. In addition, the Firm failed to identify and test any controls over the completeness of the population of new and renewed contracts used in the risk transfer analysis and the accuracy of the contract terms included in this analysis. (AS 2201.39, .42, and .44)

    - The issuer calculated the loss reserves using data as of the end of the third quarter. The issuer's Reserve Committee held meetings to review these loss reserves. As part of these meetings, the Reserve Committee evaluated significant contracts, trends in market conditions or specific contracts, and changes in methodologies or assumptions. The Firm failed to test whether the control that consisted of the review by the issuer's Reserve Committee of the loss reserves was designed and operated to address the evaluation of significant loss events that occurred during the fourth quarter (which the issuer should have considered when estimating the year-end loss reserve) and the Firm failed to identify and test any other controls that did so. (AS 2201.42 and .44)

- The issuer recorded its loss reserves based on internally developed estimates and also engaged an external actuary to evaluate the reasonableness of these estimates. The Firm failed to perform sufficient substantive procedures to test the loss reserves, as follows –

  - The Firm's procedures involved developing an independent estimate of the reserve and comparing its estimate to the estimate developed by the issuer's external actuary. The Firm concluded that these estimates were reasonably consistent without evaluating the significant differences between these estimates and the amount recorded by the issuer based on its internally developed estimates. (AS 2810.03)

  - To test risk transfer, the Firm selected the ten largest contracts for testing. The Firm failed to perform any procedures to test the remaining contracts, which presented a reasonable possibility of material misstatement. (AS 1105.27)

A.4. Issuer D

In this audit of an issuer in the information technology industry sector, 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 –

- During the year, the issuer acquired a significant business. The issuer used an external specialist to assist in estimating the fair value of the assets acquired and liabilities assumed. The Firm failed to perform sufficient procedures related to the valuation of the assets acquired and liabilities assumed. Specifically-

  - The Firm failed to identify and test any controls over the valuation of the assets acquired and liabilities assumed. (AS 2201.39)

  - The Firm's procedures to test the estimated fair values of the assets acquired and liabilities assumed were limited to (1) reading the purchase agreement and the external specialist's valuation report, (2) testing the mathematical accuracy of the supporting schedules in the valuation report, (3) tracing the estimated fair values to the general ledger, and (4) agreeing the final purchase price to supporting documents. The Firm failed to perform any procedures to evaluate the reasonableness of the assumptions used in estimating the fair values of the assets acquired and liabilities assumed. (AS 2502.05, .26 and .28)

- The Firm failed to perform sufficient procedures to test controls over income taxes. Specifically –

    - o The Firm selected for testing two controls over income taxes that consisted of management's review of the tax provision, including the deferred tax liability calculation. The Firm concluded that one of the two controls was deficient as a result of the error noted below. The Firm's procedures to test the other one of these controls consisted of (1) inquiring of the control owner, (2) reading tax memoranda and other supporting documentation, and (3) inspecting signatures that indicated reviews had occurred. The Firm failed to evaluate the nature of the review procedures that the control owner performed, including the criteria used by the control owner to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

    - o During its substantive testing, the Firm identified an error in the issuer's calculation of the deferred tax liability. The Firm, however, failed to evaluate the effect of this error on its conclusions about the design and operating effectiveness of the control described above. In addition, the Firm failed to sufficiently evaluate the severity of this control deficiency, as it considered the amount of the identified misstatement, rather than the magnitude of potential misstatement that could result from this deficiency. (AS 2201.63 and .B8)

A.5. <u>Issuer E</u>

In this audit of a manufacturer, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer offered incentive programs to its customers and recorded an accrual for these program costs. The Firm failed to perform sufficient procedures related to these accrued costs, for which it identified a fraud risk. Specifically –

- The Firm selected for testing one control related to the accrual, which consisted of the review of the reasonableness of the accrual. The Firm's procedures to test this control consisted of inquiring of management, reading memoranda prepared by the control owner as part of the operation of the control, and tracing information in one memorandum to supporting documentation. The Firm failed to evaluate the nature of the review procedures performed by the control owner, including the procedures performed to evaluate the reasonableness of the accrual. (AS 2201.42 and .44)

- The issuer's incentive programs covered a 12-month period, which concluded at the end of the issuer's third quarter. The issuer typically renewed the incentive programs for the following 12 months at the beginning of the fourth quarter. The Firm's procedures to test the accrual at year end were insufficient in the following respects –

    - To test the portion of the accrual at year end that related to incentive programs for the period ended in the third quarter of the year, the Firm tested subsequent payments. For the remainder of this portion that had not been paid as of the date of the Firm's testing, which was multiple times the Firm's established level of materiality, the Firm's procedures were limited to inquiry. (AS 2501.11)

    - To test the accrual at year end related to the renewed incentive programs, the Firm (1) obtained, and tested the mathematical accuracy of, the issuer's schedule showing the sales and incentive program activity; (2) traced amounts on the schedule to the sales register; and (3) tested the rates used to calculate the accrual. The Firm tested the rates by comparing the current year accrual percentages to the prior-year payout percentages for a sample of products and inquiring of management with respect to unexpected changes. The Firm's procedures were insufficient, as the Firm failed to obtain evidence that the current-year percentages would be consistent with the prior-year percentages. Further, the Firm failed to sufficiently evaluate unexpected changes, as the Firm's procedures were limited to inquiry. (AS 2501.11)

A.6. Issuer F

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. The Firm failed to identify, and evaluate the significance to the financial statements and the effect on the Firm's conclusions regarding ICFR of, a departure from GAAP related to the issuer's classification of certain significant accounts. (AS 2201.B8; AS 2810.30)

A.7. Issuer G

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

- The issuer's inventory located at its distribution centers was subject to daily cycle counts. The Firm selected for testing five controls that consisted of the (1) performance of daily cycle counts; (2) review of the inventory adjustment report, which listed differences that resulted from the daily cycle counts; (3) monthly review of the inventory variance report, which listed unrecorded differences; (4) monthly review of inventory write-offs that were proposed as a result of the operation of the third control; and (5) monthly reconciliation of the inventory perpetual records to the general ledger. The Firm's testing of these controls was insufficient. Specifically –

    - The Firm failed to identify and test any controls over the issuer's monitoring of the results of the daily cycle counts to assess whether its perpetual inventory records were reliable. (AS 2201.39)

    - The Firm tested the first and second controls by selecting a sample of daily cycle counts. For a small portion of the sample counts, the Firm (1) observed the issuer's cycle count procedures, (2) performed an independent count of a sample of the inventory items, (3) traced a sample of items counted that resulted in differences to the inventory adjustment reports, and (4) inspected signatures as evidence that the required reviews had occurred. For the remaining sample counts selected, the Firm's procedures were limited to inspecting the inventory adjustment reports and inspecting signatures as evidence that the required reviews had occurred. The Firm, however, failed to evaluate whether the documentation it inspected for these remaining counts provided sufficient evidence that all important steps related to the counts had been performed as designed. In addition, for the second control, the Firm failed to evaluate the nature of the review procedures that the control owner performed, including the criteria the control owner used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

- o The Firm tested the third control by inspecting signatures on a sample of inventory variance reports as evidence that the reviews had occurred and tracing one unrecorded difference noted during one of the cycle counts the Firm tested to an inventory variance report. The Firm's testing of the fourth control was limited to inspecting emails as evidence that reviews had occurred. For both controls, the Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria the control owners used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

- o The Firm failed to identify and test any controls over the accuracy and completeness of the reports used in the performance of the fifth control. (AS 2201.39)

- Due to the deficiencies described above, the Firm's testing of controls did not provide sufficient evidence, and the Firm did not perform any other procedures to obtain such evidence, that the cycle-count procedures the issuer used for this inventory were sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year. (AS 2510.11)

A.8. Issuer H

In this audit of an issuer in the health care industry sector, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. Revenue from one of the issuer's business units was multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement. The Firm failed to perform sufficient procedures to test revenue at this business unit, as follows –

- The Firm identified two deficiencies in information-technology general controls ("ITGCs") related to user access over the system used to record revenue at the business unit. The Firm identified three controls described below as compensating controls and concluded that these controls mitigated the risks associated with the ITGC deficiencies, however, each of these controls used data that were produced by the system that was subject to the ITGC deficiencies. Further, the Firm observed that the system's functionality allowed the issuer to assign specific user access levels, however, the Firm did not obtain any evidence that the user access levels were appropriately assigned, modified, and/or removed. (AS 2201.68)

- The Firm identified and tested three controls over this revenue that consisted of management's review of financial results. The Firm failed to perform sufficient procedures to test these controls. Specifically –

    - The Firm failed to sufficiently test one of the controls, which involved the monthly comparison of budgeted to actual results and review of year-to-date financial results for each of the issuer's business units and the consolidated results. The Firm's testing was limited to inquiring of the control owner and inspecting certain system-generated documents used in the operation of the control. In addition to the ITGC deficiencies noted above, the Firm failed to evaluate the nature of the review procedures that the control owner performed, including the criteria the control owner used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

    - The Firm failed to sufficiently test the other two controls, which consisted of management's review of (1) the monthly consolidated financial statements compared to the prior period, and (2) the monthly and year-to-date consolidated income statements compared to the budgeted and historical results, and the investigation of variances over certain thresholds. The Firm's procedures to test these controls consisted of (1) inquiring of the control owners, (2) inspecting certain system-generated documents used in the operation of the controls, (3) attending one meeting that constituted part of the operation of one of the controls, and (4) determining whether explanations were provided for all variances over the established thresholds. In addition to the ITGC deficiencies noted above, the Firm failed to evaluate whether these controls, which operated over the consolidated financial statements, were precise enough to prevent or detect misstatements at the business unit. (AS 2201.42 and .44)

A.9. Issuer I

In this audit of an issuer in the consumer discretionary industry sector, the Firm failed to perform sufficient procedures to test the occurrence of revenue, for which the Firm identified a fraud risk. The Firm determined its sample size for testing the occurrence of revenue based on the assurance it had obtained from other substantive procedures. These other procedures consisted of testing (1) samples of accounts receivable as of the end of the third quarter and year end, (2) a sample of invoices and unbilled accounts receivable for sales cut-off at year end, and (3) a very small number of manual journal entries. The procedures provided only limited assurance over the occurrence of revenue for the full year and, as a result, the sample that the Firm used to test revenue was too small to provide sufficient evidence. (AS 2315.19, .23, and .23A)

B. Auditing Standards

Each deficiency described in Part I.A above could relate to several provisions of the auditing standards that govern the conduct of audits. The paragraphs of the standards that are cited in Part I.A for each deficiency are only 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. Paragraphs .02, .05, and .06 of AS 1015, *Due Professional Care in the Performance of Work*, require the independent auditor to plan and perform his or her work with due professional care and set forth aspects of that requirement. AS 1015.07-.09, and paragraph .07 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, 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 2301.03, .05, and .08 require the auditor to design and implement audit responses that address the risks of material misstatement. Paragraph .04 of AS 1105, *Audit Evidence*, 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. Appropriateness is the measure of the quality of audit evidence; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

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.

PCAOB Auditing Standards	Audits	Number of References per Audit
AS 1105, *Audit Evidence*	Issuer C	1
AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	Issuer A Issuer B Issuer C Issuer D Issuer E Issuer F Issuer G Issuer H	4 7 2 3 1 1 4 3
AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer A Issuer B	2 1
AS 2315, *Audit Sampling*	Issuer A Issuer B Issuer I	4 1 1
AS 2501, *Auditing Accounting Estimates*	Issuer A Issuer B Issuer E	1 3 2
AS 2502, *Auditing Fair Value Measurements and Disclosures*	Issuer D	1
AS 2510, *Auditing Inventories*	Issuer G	1
AS 2810, *Evaluating Audit Results*	Issuer A Issuer C Issuer F	1 1 1

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

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

	AS 1105	AS 2201	AS 2301	AS 2315	AS 2501	AS 2502	AS 2510	AS 2810
Accrued program costs		E			E			
AFS securities		B						
Business combinations		D	A	A		D		
Debentures		B						
Income taxes		D						
Information technology		H						
Inventory and related reserves		G					G	
Loans, including ALL		B	B	B	B			
Loss reserves	C	C						C
Revenue, including accounts receivable and deferred revenue		A, H	A	A, I	A			A
Other		F						F

B.3. Audit Deficiencies by Industry

The table below lists the industries[6] 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.

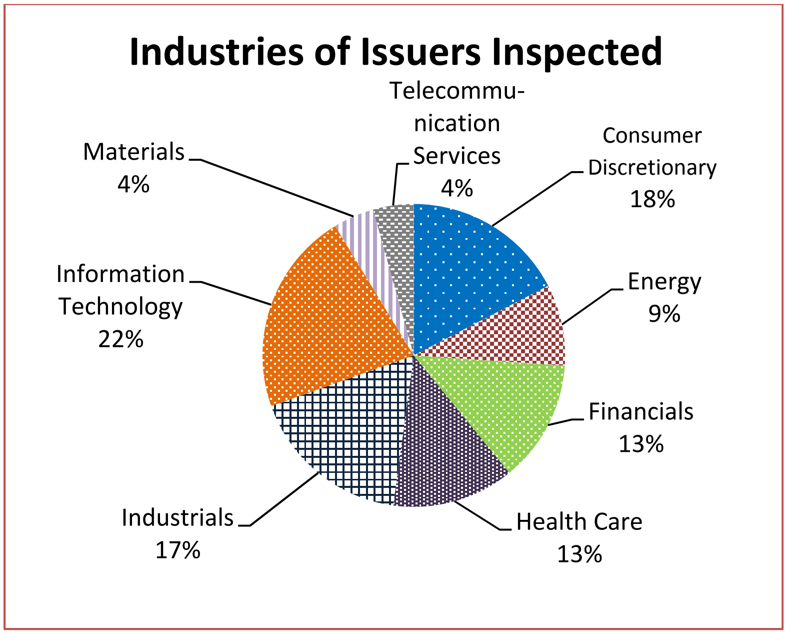
	AS 1105	AS 2201	AS 2301	AS 2315	AS 2501	AS 2502	AS 2510	AS 2810
Consumer Discretionary		G		I			G	
Financials	C	B, C	B	B	B			C
Health Care		H						
Information Technology		D				D		
Other		A, E, F	A	A	A, E			A, F

[6] 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.

C. Data Related to the Issuer Audits Selected for Inspection

C.1. Industries of Issuers Inspected

The chart below categorizes the 23 issuers whose audits were inspected in 2017, based on the issuer's industry.[7]



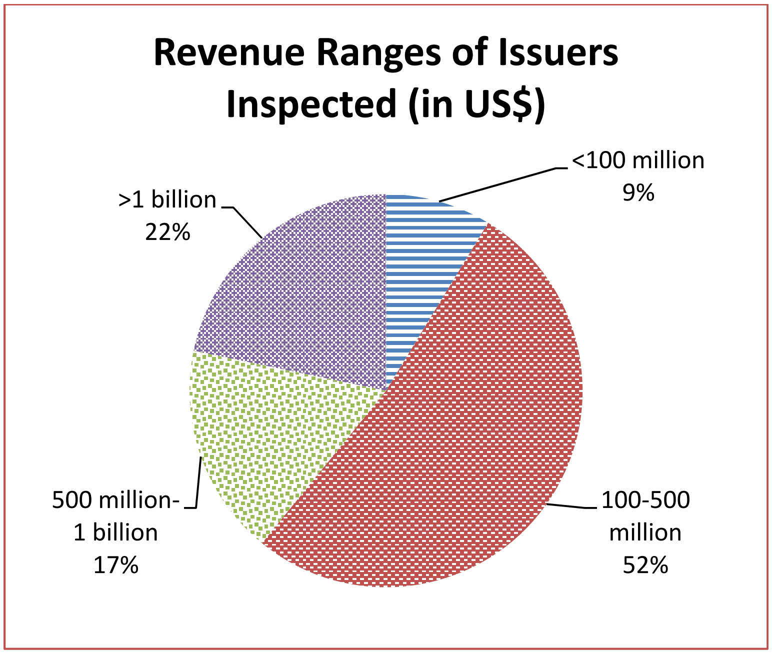
Industry	Number of Audits Inspected	Percentage
Consumer Discretionary	4	18%
Energy	2	9%
Financials	3	13%
Health Care	3	13%
Industrials	4	17%
Information Technology	5	22%
Materials	1	4%
Telecommunication Services	1	4%
Total	23	100%

---

7 See Footnote 6 for additional information on how industry sectors were classified.

C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 23 issuers whose audits were inspected in 2017.[8] This presentation of revenue data is intended to provide information related to the size of issuers whose audits 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.



Revenue (in US$)	Number of Audits Inspected	Percentage
<100 million	2	9%
100-500 million	12	52%
500 million -1 billion	4	17%
>1 billion	5	22%
Total	23	100%

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

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

This section provides a brief description of the procedures that are often performed in annual inspections of auditing firms.

D.1. Reviews of Audit Work

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. For each specific portion of the audit that is selected, the inspection team 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 review of any 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. 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.[9]

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,[10] as well as a firm's failure to perform,

---

[9] The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

[10] 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

or to perform sufficiently, certain necessary risk assessment procedures, tests of controls, and substantive audit procedures.

In reaching its conclusions about whether a deficiency exists, 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 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 1215, *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 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.

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

---

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.

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

---

[11] 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.

[12] 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.

quality control. A description of the procedures generally applied to these areas is below.

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

Procedures in this area are designed to focus on (1) how management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance and (2) whether actions and communications by the firm's leadership – the tone at the top – demonstrate a commitment to audit quality. To assess this area, the inspection team may interview firm personnel, including firm leadership, and review significant management reports, communications, 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 of material misstatement 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 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 processes 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 and operation of the firm's internal inspection program, and may compare the results of its review 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

PARTS II AND III OF THIS REPORT ARE NONPUBLIC
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX A

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.[13]

[13] 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 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.

Tel: 212-885-8000
Fax: 212-697-1299
www.bdo.com

100 Park Avenue
New York, NY 10017

June 7, 2019

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

Re: Response to Part I of the Draft Report on the 2017 Inspection of BDO USA, LLP

Dear Mr. Botic:

We are pleased to provide our response to Part I of the Public Company Accounting Oversight Board's ("PCAOB") Draft Report on the 2017 inspection of BDO USA, LLP.

We have evaluated each of the matters described in Part I of the Draft Report and have taken appropriate actions under both PCAOB standards and our policies, including all necessary steps to comply with AS 2901, *Consideration of Omitted Procedures After the Report Date*, and where applicable, AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

We remain committed in making audit quality our top priority. The PCAOB's inspection process assists us in improving our audit performance and our underlying quality control systems. We look forward to continuing to work with the PCAOB on the most effective means of achieving this objective.

Respectfully submitted,

BDO USA, LLP

APPENDIX B

AUDITING STANDARDS REFERENCED IN PART I

This appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this appendix, and any other Notes, are from the original auditing standards that are referenced. While this appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at http://pcaobus.org/STANDARDS/Pages/default.aspx.[14]

AS 1105, *Audit Evidence*		
Selecting Specific Items		
AS 1105.27	The application of audit procedures to items that are selected as described in paragraphs .25-.26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[12]	Issuer C
Footnote to AS 1105.27 [12] If misstatements are identified in the selected items, *see* AS 2810.12 - .13 and AS 2810.17 - .19.		

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
PLANNING THE AUDIT		
Selecting Controls to Test		
AS 2201.39	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, and G
TESTING CONTROLS		
Testing Design Effectiveness		

[14] The text presented in this appendix represents the standards as in effect during the applicable audit period.

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
AS 2201.42	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. 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.	Issuers A, B, C, D, E, G, and H
Testing Operating Effectiveness		
AS 2201.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	Issuers A, B, C, D, E, G, and H
EVALUATING IDENTIFIED DEFICIENCIES		
AS 2201.63	The severity of a deficiency depends on – ▪ Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and ▪ The magnitude of the potential misstatement resulting from the deficiency or deficiencies.	Issuer D

AS 2201, ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***		
AS 2201.68	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 H
APPENDIX B - Special Topics		
INTEGRATION OF AUDITS		
AS 2201.B8	*Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum – ▪ The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud. ▪ Findings with respect to illegal acts and related party transactions. ▪ Indications of management bias in making accounting estimates and in selecting accounting principles. ▪ Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.	Issuers D and F

AS 2301, ***The Auditor's Responses to the Risks of Material Misstatement***		
TESTING CONTROLS		
Testing Controls in an Audit of Financial Statements		
AS 2301.16	*Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do	Issuers A and B

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*		
	so.	
<u>Footnotes to AS 2301.16</u> [12] 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. [13] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.		
AS 2301.18	*Evidence about the Effectiveness of Controls in the Audit of Financial Statements*. 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 and B
SUBSTANTIVE PROCEDURES		
AS 2301.37	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 and B

AS 2315, *Audit Sampling*		
SAMPLING IN SUBSTANTIVE TESTS OF DETAILS		
Planning Samples		
AS 2315.19	After assessing and considering the levels of inherent and control risks, the auditor performs substantive	Issuers A, B, and I

AS 2315, *Audit Sampling*		
	tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases 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.[3] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	
Footnote to AS 2315.19 3 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.		
AS 2315.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.	Issuers A, B, and I
AS 2315.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuers A, B, and I

<table>
<tr><td colspan="3">AS 2501, Auditing Accounting Estimates</td></tr>
<tr><td>EVALUATING REASONABLENESS</td><td></td><td></td></tr>
<tr><td>AS 2501.11</td><td>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:

a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
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.
c. Consider whether there are additional key factors or alternative assumptions about the factors.
d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
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.
f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
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.
h. Consider using the work of a specialist regarding certain assumptions (AS 1210, Using the Work of a Specialist).
i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.</td><td>Issuers A, B, and E</td></tr>
</table>

AS 2502, *Auditing Fair Value Measurements and Disclosures*		
INTRODUCTION		
AS 2502.05	Fair value measurements for which observable market prices are not available are inherently imprecise. That is because, among other things, those fair value measurements may be based on assumptions about future conditions, transactions, or events whose outcome is uncertain and will therefore be subject to change over time. The auditor's consideration of such assumptions is based on information available to the auditor at the time of the audit. The auditor is not responsible for predicting future conditions, transactions, or events that, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures.[2]	Issuer D
Footnote to AS 2502.05 [2] For purposes of this section, management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management.		
EVALUATING CONFORMITY OF FAIR VALUE MEASUREMENTS AND DISCLOSURES WITH GAAP		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AS 2502.26	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 whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (*see* paragraph .06). b. The fair value measurement was determined using an appropriate model, if applicable. c. Management used relevant information that was reasonably available at the time.	Issuer D
AS 2502.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management	Issuer D

AS 2502, *Auditing Fair Value Measurements and Disclosures*		
	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.	

AS 2510, *Auditing Inventories*		
INVENTORIES		
AS 2510.11	In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances.	Issuer G

AS 2810, *Evaluating Audit Results*		
EVALUATING THE RESULTS OF THE AUDIT OF FINANCIAL STATEMENTS		
AS 2810.03	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 C
Evaluating the Presentation of the Financial Statements, Including the Disclosures		
AS 2810.30	The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting	Issuers A and F

AS 2810, *Evaluating Audit Results*		
	framework. Note: AS 2815, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles,"* establishes requirements for evaluating the presentation of the financial statements. AS 2820, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements. 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.	