

**Report on**  
**2003 Limited Inspection**  
**of PricewaterhouseCoopers LLP**

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

**August 26, 2004**

**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**

### **Notes Concerning this Report**

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the regulatory supervisory context in which this report was prepared. Discussions of the Board's or Board staff's views on such matters are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. In connection with inspections of registered public accounting firms, the Board and its staff consider whether the firm, in its audits of financial statements, has failed to identify departures from Generally Accepted Accounting Principles (GAAP). This report's descriptions of such failures necessarily involve descriptions of the Board and Board staff's view of the relevant GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("Commission" or "SEC"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.
4. The audit engagements reviewed during this limited inspection concerned financial statements for periods that ended before the relevant standards (then referred to as Generally Accepted Auditing Standards or "GAAS") were adopted by the PCAOB on an interim basis as the PCAOB standards that, under the Act, now govern the audits of the financial statements of issuers. For consistency with the Board's approach to this issue in other contexts, this inspection report refers to the applicable standards as PCAOB standards even with respect to periods before the Board adopted the standards. *Cf.* Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board, PCAOB Release No. 2003-025 (Dec. 17, 2003) (approved by the Commission, May 14, 2004).

## **INSPECTION REPORT OVERVIEW**

In 2003, the Public Company Accounting Oversight Board conducted inspections of public accounting firms for the first time. The Board inaugurated its inspection program with limited inspections of the four largest U.S. public accounting firms, including PricewaterhouseCoopers LLP, the subject of this report. In those inspections, the Board identified significant audit and accounting issues that were missed by the firms, and identified concerns about significant aspects of each firm's quality controls systems. The Board's inspection reports describe those issues. Because Board inspections and inspection reports are new, however, the Board offers a few remarks by way of providing readers with a context for the observations described in this report.

The Board's statutorily prescribed mission is to oversee auditors of public companies in order to protect the interests of investors and to further the public interest in the preparation of informative, fair, and independent audit reports. To advance that mission, Board inspections take up the basic task that had been the province of the accounting profession's peer review system, but Board inspections do not duplicate the programs and approach of peer review.

Board inspections do, of course, examine technical compliance with professional accounting and auditing standards, but Board inspections also examine the business context in which audits are performed, and the ways in which that context influences firm audit practices. Among other things, the Board looks at firm culture, the relationships between a firm's audit practice and its other practices, and the relationship between a firm's national office and its engagement personnel in field and affiliate offices. Through this approach, the Board believes that it can help bring about constructive change in the types of practices that contributed to the most serious financial reporting and auditing failures of the last few years.

Toward that end, an essential ingredient of the Board inspection process is an unflinching candor with firms about the points on which we see a need for improvement. That emphasis may often result in inspection reports that appear to be laden with criticism of a firm's policies, practices, and audit performance, and less concerned with a recitation of a firm's strengths. That is because, from the Board's perspective, the inspection reports are not intended to serve as balanced report cards, rating tools, or potential marketing aids for any firm. The reports are intended principally to focus our inspection-related dialogue with a firm on those areas where improvement is either required for compliance with relevant standards and rules, or is likely to enhance the quality of the firm's audit practice.

The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspected in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.

Moreover, the Board does not doubt that the bulk of the firms' audit professionals consists of skillful and dedicated accountants who strive – at times against the competing priorities of the large and complex business of the firms – to make audit quality their top priority. The Board is encouraged by the increasing tendency of persons at the highest levels of the firms to speak of the need for a renewed commitment to audit quality as the firm's top priority. The Board is also encouraged by the firms' recognition of the value of the Board's inspection process. The Board will continue to use its inspection authority to focus the firms on aspects of their practice that may stand as an impediment to the highest quality audit performance.

PCAOB Release No. 104-2004-005

## **2003 LIMITED INSPECTION OF PRICEWATERHOUSECOOPERS LLP**

In 2003, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted a limited inspection of PricewaterhouseCoopers LLP ("PwC"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part III of the report. Part III of the report consists of the firm's comments on a draft of the report.<sup>1/</sup>

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.<sup>2/</sup> A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

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<sup>1/</sup> The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change in the report.

<sup>2/</sup> See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

## **PART I**

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

Members of the Board's Inspection staff ("the staff") performed a limited inspection of PwC during the period from June 2003 through January 2004. The staff performed field work at PwC's national office and at four of its practice offices. The staff also observed and tested aspects of PwC's internal inspection program at two additional practice offices.

The limited inspection included a review of certain portions of selected audit engagements and a review of policies and procedures in the following seven functional areas, which were selected based on criteria identified by the Board:

- Tone at the top;
- Practices for partner evaluation, compensation, promotion, and assignment of responsibility;
- Independence implications of non-audit services; business ventures, alliances and arrangements; and commissions and contingent fees;
- Client acceptance and retention;
- The firm's internal inspection program;
- Practices for establishment and communication of audit policies, procedures and methodologies, including training; and
- The supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. audit clients.

Part I.A below provides a description of the steps that the staff took with respect to the review of audit engagements and the review of the seven functional areas. Following that, Part I.B describes, at a general level, certain observations concerning PwC's audit performance as observed in the review of audit engagements. The public portion of this report then concludes with certain general observations in Part I.C.

## **A. The Inspection Process**

The staff carried out extensive procedures related to PwC's public company audit practice. Even so, the Board emphasizes the limited nature of this initial inspection of PwC compared to the scope of the inspections that we intend to conduct for large firms as we go forward. Although the practical considerations in creating a new inspection program (including the time required to enlist a sufficient number of appropriately skilled staff) prevented the Board from conducting full-scale inspections in 2003, the Board determined that conducting limited inspections was feasible and would advance the public interest by providing a foundation for the full-scale inspections to come.

### **1. Review of Selected Audit Engagements**

At the outset of the inspection, the staff selected 16 audit engagements to review. The staff chose the engagements according to the Board's own criteria. As with any Board inspection, PwC was not allowed an opportunity to limit or to influence the selection process.

For each audit engagement selected, the staff began by reviewing the issuer's financial statements and Form 10-K and certain (generally the most recent) quarterly reports on Form 10-Q. The staff selected certain subject matter areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those subject matter areas. The subject areas for review included, but were not limited to, revenues, reserves or estimated liabilities, goodwill and fixed asset impairment analyses, supervision of work performed by foreign affiliates, and the assessment of risk by the audit team. The staff analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. The staff also interviewed, by phone, the Chair of the issuer's audit committee and reviewed communications between the firm and the audit committee.<sup>3/</sup>

When the staff identified a potential issue, the staff discussed the issue with members of the audit engagement team. If the staff was unable to resolve the issue through this discussion and any resultant review of additional work papers or other documentation, the staff documented the issue on a comment form that was submitted to PwC for its review and response. In many cases, this consultation process resulted in resolution of the matter, either because PwC

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<sup>3/</sup> In one instance, at the Audit Committee Chair's request, the staff conducted a telephone interview of the entire audit committee.

agreed with the position the staff had taken and the firm or the issuer took adequate steps, in light of the significance of the error, to remedy the exception, or because PwC was able to provide additional information that effectively addressed the staff's concerns.

## 2. Review of Seven Functional Areas

The staff conducted its review of the seven functional areas primarily at PwC's national office, but also completed certain procedures at the four practice offices. At the national office, the staff interviewed numerous members of the firm's leadership; read the firm's policies and procedural guidance; analyzed other source documents relating to the functional areas inspected; and reviewed communications from the national office to firm personnel. These actions were performed in order to understand PwC's policies and processes in the seven functional areas, evaluate their design and operation, and test compliance on a limited basis with those policies and procedures.

At the practice offices, the staff analyzed the consistency with which the practice offices applied the policies and procedures established by the national office, and evaluated whether communications from the national office were effective and were reinforced within the practice offices. To accomplish these goals, the staff interviewed office leadership, audit partners and senior managers and reviewed relevant documentation. The staff also conducted focus group interview sessions with audit senior associates and managers, outside the presence of office leadership and on a not-for-attribution basis. In these sessions, the staff encouraged the participants to discuss their understanding of the messages conveyed by the firm and office leadership, and how these messages might affect the participants' actions.

Naturally, each of the functional areas reviewed involved a scope of materials and procedures particular to it. A more detailed description of the scope with respect to each of the seven functional areas is set out below.

### a. *Review of Tone at the Top*

The primary objective of the review of the firm's "tone at the top" was to assess whether the firm's leadership's actions and communications demonstrate a commitment to audit quality and compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the SEC, and professional standards in connection with the firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the staff read, reviewed, and analyzed the following information at the national office:

- PwC's code of conduct for firm employees;
- Documentation related to the firm's Ethics Helpline,
- Organizational charts, duties of the firm's governing board, and biographies of governing board members;
- Information concerning reporting relationships;
- Ten public company audit proposals;
- The most recent client and audit committee surveys used to evaluate the client's or audit committee's satisfaction with services provided by the firm;
- Information concerning the roles and responsibilities of each engagement team member;
- The strategic business plan of the firm;
- The financing structure of the firm;
- Certain communications from management;
- Certain internal firm publications;
- Agendas and minutes of the management committee and Board of Partners; and
- Certain presentations and speeches by the firm's Chief Executive Officer.

In addition, the staff interviewed 23 members of the firm's leadership team.

The staff also performed procedures at each of the four practice offices. The staff interviewed the practice office leadership, including the office managing partner, the Assurance and Business Advisory Services (ABAS) managing partner, a risk management partner and selected other business and professional leaders. In addition, the staff interviewed several ABAS partners and senior managers to obtain their perspectives on communications from the firm's leadership related to audit quality and the tone at the top.

At each of the four practice offices visited, the staff also conducted two separate focus group meetings with six to 10 ABAS managers and six to 10 audit senior associates. The purpose of the focus group meetings was to assess the participants' understanding of, among other things, the messages conveyed by the firm, office leadership and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top.

*b. Review of Partner Evaluation, Compensation, Promotion, and Assignment of Responsibility*

The objectives of the inspection procedures in this area were to assess the firm's current policies and procedures for evaluating partner performance and determining partner compensation; to determine the relative weight the firm gives to marketing vs. audit quality and technical competence in admitting new partners, measuring partner performance, establishing partner compensation and other rewards, assigning responsibilities to partners, and in disciplining partners; and to evaluate whether the design of the measurement, evaluation and compensation processes as documented and communicated could be expected to achieve the objectives of promoting audit quality.

In pursuit of these objectives, the staff requested that the firm provide certain documentation related to partner evaluation, compensation, promotion, and assignment of responsibility. The staff read, reviewed and analyzed the firm's policies and procedures related to the following:

- Evaluation of partner performance;
- Determination of partner compensation;
- Process for nomination and admission of new partners; and
- Assignment of duties and termination or re-assignment of partners.

The staff also –

- Reviewed schedules and supporting details that included each partner's line of service, business unit, work office location, years as a partner, age, responsibility level, and other information;
- Reviewed lists of inactive partners, newly retired partners, and new partners;

- Selected a sample of 25 partners and reviewed each partner's ABAS Fiscal 2003 Partner Plan/Appraisal to assess the factors used by the firm in establishing the partner's compensation;
- Selected samples of 25 newly admitted partners from within the firm and 22 direct (outside the firm) partner admissions in order to assess whether the stated rationale for the decision to admit the candidate to the partnership was consistent with firm policies and the candidate's files, and evaluated the roles that technical competence and sales or marketing played in the decision;
- Interviewed members of the Board, the Chairman and CEO, the national partner in charge of the internal inspection program, the national partner in charge of partner affairs, the COO, line-of-service leaders, and the national partner in charge of Risk and Quality ("R&Q") to understand the process of determining partner compensation.

The staff's procedures at the four practice offices included:

- Interviews with the partner in charge of each engagement selected for inspection and in most instances, one other partner assigned to that engagement to determine how the partner allocates his or her time during the year; the effects that the partner compensation policies have on that allocation; and the relative effects the partner believes audit quality, selling, and technical competence have on his or her compensation, evaluation, and advancement within the partner ranks. Further, the staff reviewed the personnel files of those partners to assess whether their prior evaluations support their assignment to the audit engagements being inspected;
- Interviews with area leadership, including managing partners, partners in charge of ABAS and partners with risk management responsibilities, concerning the performance of the engagement partners whose engagements were inspected, and the new partner admissions process.

*c. Review of Independence Policies*

The objectives of the inspection procedures in this area included gaining an understanding of certain PwC policies and procedures relating to the firm's compliance with independence requirements. In particular, the staff focused on independence issues related to the provision of non-audit services to issuer

clients and concerning the firm's business ventures, alliances, and arrangements. The staff also reviewed the firm's requirements regarding personal holdings of securities as well as its programs designed to monitor compliance with those policies. To accomplish these objectives, the staff reviewed the firm's policies, procedural guidance and training materials pertaining to independence matters. The staff –

- Gained an understanding of the firm's global independence organizational structure and the responsibilities of the U.S. Independence Office;
- Read and evaluated the firm's policies, procedures, and guidance materials related to permissible service arrangements with audit and non-audit clients, and value-added, findings-based and contingent fee arrangements;
- Reviewed the firm's policies regarding establishing business ventures, arrangements and alliances (collectively, "Business Relationships") and reviewed a sample of the firm's Business Relationships for compliance with the SEC independence rules;
- Gained an understanding of the firm's internal independence inspection programs;
- Reviewed the firm's independence training programs; and
- Interviewed several partners responsible for independence matters, including the R&Q Leader, the Global Independence Leader and the U.S. Independence Leader.

The staff's procedures at the four practice offices included interviews with 16 audit partners, on engagements the staff reviewed, regarding the provision of non-audit services to issuer audit clients. For a sample of engagements, the staff also reviewed relevant information to identify any non-audit services performed for the issuer, as well as any business ventures, alliances, or arrangements with the issuer; and to determine whether the fees for the services provided are classified appropriately in the issuer's proxy statement. In addition, the staff read and evaluated the most recent letter pursuant to Independence Standards Board (ISB) Standard No. 1, *Independence Discussions with Audit Committees*.

*d. Review of Client Acceptance and Retention Policies*

The primary objectives of the staff's inspection procedures in this area were to evaluate whether the firm's client acceptance and retention policies and procedures reasonably assure that the firm is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the staff read, reviewed and analyzed the following information at PwC's national office:

- The policies and procedures for acceptance and continuance of audit clients, including policies and guidance for clients designated as "higher risk" by the firm's risk evaluation system;
- The forms used in the acceptance and continuance processes;
- For all issuers that ceased to be audit clients during the period July 2002 - June 2003, information including the issuer's name, the date of the Form 8-K reporting the change in the issuer's certifying accountant, whether the firm was dismissed or resigned, and a copy of the firm's SEC Practice Section termination/resignation letter to the issuer and the SEC confirming that the client-auditor relationship had ceased;
- For certain issuer clients, a copy of Item 4 of the Form 8-K that reported the change in auditors;
- A list of all issuer clients that were accepted as new clients during the period July 2002 through June 2003, including the issuer's year-end, the names of the engagement leader and manager, and the city where the work was performed; and
- A list of 32 prospective issuer clients rejected during the client acceptance process.

The staff also:

- Reviewed the documentation related to six potential issuer clients that ultimately were rejected and five "lost clients" for compliance with the firm's policies and procedures and professional and regulatory requirements in this area;

- Interviewed members of the Board, the Chairman and CEO, the national partner in charge of risk management, the CFO, the COO and four major service line leaders to obtain an understanding of the client acceptance and continuance practices and procedures;
- Read and evaluated 22 issuer client acceptance packages and 15 issuer client retention packages and evaluated whether the packages were appropriately completed and approved.

At the four practice offices the staff:

- Interviewed seven partners and seven managers on five new issuer clients and two existing issuer clients that were rated higher risk;
- Read and evaluated 12 issuer client retention packages and evaluated whether the packages were appropriately completed and approved; whether specific risk mitigation procedures were developed and documented as part of the continuance process; and, where applicable, evaluated whether the audit work papers incorporated the risk mitigation procedures.

*e. Review of Internal Inspection Program*

The objectives of the inspection procedures in this area were to evaluate the effectiveness of the firm's annual internal inspection program in enhancing audit quality, including evaluating the results and the remedial actions taken, and to observe and test the conduct of the internal inspection program in one practice office to assess compliance with the quality control standards adopted by the Board.

The staff read, reviewed and analyzed the following information related to the firm's internal inspection program:

- Policies and procedures for the Risk and Quality Review (RQR), including the program's goals and objectives, and the methods of selecting offices, partners and engagements to be reviewed;
- The RQR audit engagement questionnaire, engagement profile information form, reviewer profile forms, and a copy of the matter sheets used to document findings by the reviewer;
- The results of the 2003 internal inspection program, certain summary matter sheets and the evaluation of the results; and

- Documentation of presentations to the Board and communications to partners and professional staff on the 2003 RQR and peer review results.

Further, the staff conducted interviews with the U.S. Audit Quality Leader, who is the partner in charge of the internal inspection program, and gained an understanding of the program and process. The staff also interviewed members of the Board, the Chairman and CEO, the partner in charge of risk management and audit policy, the CFO, the COO, major industry service line leaders, and the firm's top technical partner. In the practice offices, the staff interviewed the office managing partner, ABAS office leader and a risk management partner, and selected audit business and professional leaders, including senior managers.

The staff reviewed and tested the conduct of the internal inspection program in one practice office and reviewed the Deloitte & Touche LLP ("Deloitte") peer review of PwC in another practice office. The staff performed the following procedures:

- Reviewed and evaluated the qualifications and experience of the firm's inspectors;
- Reviewed two of the 214 issuer client engagements reviewed by the PwC internal inspectors and three of the 124 audit and other attest engagements reviewed by the Deloitte peer review team and performed the following procedures:
  - Read the issuer's financial statements and the firm's audit report;
  - Read selected "critical matter" documents;
  - Reviewed the engagement team's work papers for several areas;
  - Read the matter sheets and other documentation of the review that PwC's internal inspectors had prepared;
  - Attended certain of the closing meetings between the engagement teams and PwC's internal inspectors;

- Attended the closing meeting for the practice office subjected to the Deloitte peer review; and
  - Compared the staff's findings with those of the PwC internal inspectors and Deloitte peer review team, and discussed and followed up with the firm on any significant differences.
  - Read the inspection report and a summary of selected matter sheets for the internal inspection of the practice office, and attended the closing meeting for the practice office.
- f. Review of Practices for Establishment and Communication of Audit Policies, Procedures and Methodologies, Including Training*

The objectives of the inspection procedures in this area were to obtain an understanding of the firm's processes for establishing and communicating audit policies, procedures and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; to evaluate changes in audit policy that the firm has made; and to evaluate the content of the firm's training on the recently issued Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* ("SAS 99").

The staff read and analyzed the following information:

- Memoranda containing brief explanations of how the firm develops and revises its policies and procedures;
- Documentation of the changes made to firm policies and procedures from May 2002 through July 2003;
- Excerpts from the firm's global policies and procedures manual and other internal guidance on SAS 99; and
- Training materials for SAS 99 training programs conducted for U.S. audit professionals.

The staff also:

- Interviewed the firm's Americas Theater Risk Management Leader to determine how the firm incorporates and communicates changes in its audit policies, procedures and methodologies;

- Evaluated the effectiveness of the design of the processes for monitoring changes that might require additions to or changes in the firm's audit policies, procedures and methodologies; and
- Evaluated the nature and content of recent additions to, or changes in, selected firm audit policies, including those resulting from SAS 99, SAS 100, *Interim Financial Information*, and the SEC's rules on auditor independence (SEC Release 33-8183) and on "Improper Influence on Conduct of Audits" (SEC Release 34-47890).

*g. Review of Policies Related to Foreign Affiliates*

The objective of the inspection procedures in this area was to evaluate the processes the firm uses to ensure that the audit work performed by its non-U.S. PwC affiliates on the foreign operations of U.S. issuers is reliable and in accordance with PCAOB standards. The staff did not inspect the audit work of foreign affiliates; rather, the inspection procedures with respect to such work were limited to a review of evidence of the supervision and control, in accordance with standards established by the Board, exercised by the U.S. firm over such work.

The staff read, reviewed and analyzed:

- Policies and procedures related to the U.S. firm's supervision and control of work performed by the firm's non-U.S. PwC affiliates on the foreign operations of U.S. issuer audit clients, including those related to:
  - How the U.S. firm ascertains the professional reputation of the affiliated firms;
  - Procedures the U.S. firm employs to obtain reasonable assurance that the non-U.S. PwC affiliates and their personnel comply with the SEC's independence requirements;
  - Procedures the U.S. firm employs to obtain reasonable assurance that personnel of the affiliated firms responsible for performing the work on the foreign operations of U.S. issuer clients are familiar with U.S. GAAP, PCAOB standards, SEC independence rules, and relevant SEC financial reporting requirements; and

- Procedures the U.S. firm employs to obtain reasonable assurance that non-U.S. PwC affiliates and their personnel understand and comply with relevant audit policies and procedures of the U.S. firm;
- Audit guidance related to planning and administering multi-location engagements, including evaluating fraud at individual locations, identifying significant accounts and processes, allocating audit materiality to locations, and performing risk assessments and customized audit solutions and training;
- The "ABAS Quality Review Program – 2002 Global Summary Report" on the results of the most recent internal inspection of the firm's foreign affiliates;
- Evidence related to whether professional employees in foreign affiliated firms assigned to U.S. issuer clients have sufficient familiarity with U.S. GAAP and PCAOB standards, independence rules, relevant financial reporting requirements, and the applicable policies of the U.S. firm, including:
  - Examples of foreign affiliates' U.S. GAAP and PCAOB standards training curricula;
  - The firm's tool for providing information on international auditing and accounting issues;
  - Documents related to the national office's involvement with U.S. multinational engagement teams on U.S. GAAP, PCAOB standards and related SEC accounting questions and engagement execution; and
  - The foreign affiliates' annual confirmations of compliance with PwC's global independence policies.

The staff also interviewed those responsible for oversight of the work performed by non-U.S. PwC affiliates on foreign operations of U.S. issuer clients to assist in our understanding and evaluation of the process. The staff interviewed the partners responsible for the global internal inspection program, international training and compliance with the independence rules on a global basis.

Procedures at the four practice offices included inspecting, as part of the engagement reviews, two audit engagement teams' supervision and control procedures over the audit work performed by the firm's non-U.S. PwC affiliates on the foreign operations of the U.S. issuers to evaluate whether those supervision and control procedures complied with PCAOB and firm standards.

## **B. Observations Concerning Audit Performance**

As part of the 2003 limited inspection of PwC, the staff reviewed certain portions of 16 audit engagements. The selected engagements involved audits of issuers for fiscal years ended during the last half of 2002 through the first half of 2003. In addition, the staff's review of PwC's internal inspection program, and of its most recent peer review, involved or resulted in the staff reviewing aspects of five additional engagements. The staff also requested that PwC review the accounting by six issuers for compliance with the provisions of Emerging Issues Task Force No. 95-22 ("EITF 95-22"), *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.<sup>4/</sup> Based on a review of relevant documents filed with the SEC, the staff had concluded that the financial statements of three of these issuers appeared not to conform with the provisions of EITF 95-22 and that the firm should ascertain whether the financial statements of the other three issuers conform with the provisions of EITF 95-22.

This section describes, at a general level, certain deficiencies in PwC's audit performance as observed in this review of audit engagements. In some of the engagements reviewed, the staff identified errors in the application of GAAP that PwC had either not identified or not appropriately addressed during the audit. In addition to those engagements, the staff's prompting of PwC to review the potential misapplication of EITF 95-22 by six other audit clients led to three of those issuers restating their financial statements. In addition, some of the audit engagements reviewed were found to involve some degree of departure from PCAOB standards or PwC's own quality control policies or both.

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<sup>4/</sup> The Board's staff made this same request concerning EITF 95-22 to each of the four firms inspected by the Board in 2003.

1. Failure to Identify or Address GAAP Exceptions

a. *Staff Discoveries Resulting in Restatements by Issuers*

Three PwC clients have restated their balance sheets to address GAAP exceptions as a result of the staff bringing the EITF 95-22 issue to PwC's attention. The provisions of EITF 95-22 require that balances under revolving lines of credit must be classified as current liabilities of the borrower if the loan agreements contain both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances whereby remittances from the borrower's customers immediately reduce the outstanding obligation. PwC had failed to identify that the three issuers in question had incorrectly classified such debt as a long-term liability. The effect of this misclassification was to understate current liabilities and, thereby, to overstate working capital. In each case, PwC agreed with the staff's view, and the issuer restated certain financial statements to classify the debt as a current liability.

b. *Other GAAP Exceptions*

The staff identified the presence of various other GAAP exceptions. In each case, the issuer and PwC concluded that the findings were immaterial, individually and in the aggregate. Nonetheless, in some of these cases, the issuer determined to change its accounting, or PwC determined to recommend accounting changes or enhanced disclosure in future financial statements.<sup>5/</sup>

(1) One issuer received rebates from certain of its vendors whose products the issuer buys for resale. The issuer included the total balance of vendor rebates (which represented over 60 percent of the reported balance) as a component of trade accounts receivable. Trade accounts receivable are typically due from customers, not from vendors, and Rule 5-02(3) of SEC Regulation S-X requires issuers to disclose separately receivables from customers (trade) and other receivables. The staff concluded that the rebates receivable that are due from vendors should be disclosed separately from trade accounts receivable. While the engagement team maintained that the presentation of vendor rebates receivable within trade accounts receivable was at least acceptable within the industry, it has informed the staff that, beginning in 2003, the issuer will separately disclose the rebates receivable balance and, at that time, will disclose the 2002 rebates receivable balance to conform to the 2003 presentation.

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<sup>5/</sup> Even if immaterial to current financial statements, some GAAP errors present the potential to be material to future financial statements if the accounting is not corrected.

(2) Review of one issuer's financial statements for 2002 led the staff to discover that the issuer's financial statements for both 2002 and 2001 failed to disclose certain guarantees related to leases that the issuer had transferred in connection with the sale of assets in a prior period. The sale was significant to the issuer and was made to a company controlled, at that time, by a director of the issuer. At the time of the sale in an earlier year, PwC was not the issuer's auditor. PwC audited the issuer's financial statements for 2002 and had also (before, and unrelated to, the Board's inspection) performed a re-audit of the issuer's financial statements for a prior period after the sale. As an element of PwC's audit work, the engagement team reviewed the sale documents in order to evaluate the propriety of the original accounting for the transaction. According to the PwC engagement partner, however, until certain events occurred in 2003 that resulted in the lessors' assertion of a right of recovery pursuant to the issuer's lease obligations and to the issuer's recording of a reserve for losses relating to these guarantees in interim 2003 financial statements, PwC was not aware of the existence of the lease guarantees.

The staff concluded that the failure to disclose those guarantees was not in accordance with SFAS No. 5, *Accounting for Contingencies* ("SFAS No. 5") and Financial Accounting Standards Board (FASB) Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45"). PwC responded to the staff that the firm and the issuer agree that the lease guarantees should have been disclosed, in accordance with SFAS No. 5, in the 2002 annual report. PwC also told the staff that the firm and the issuer do not believe the matter requires restatement of any financial statements. The issuer subsequently disclosed the existence of the lease guarantees in a 2003 Form 10-Q,<sup>6/</sup> but failed to make all the required disclosures under SFAS No. 5.

2. Departures from PCAOB Standards and/or from PwC's Own Quality Control Policies

a. *Staff Discoveries That Led to Additional Procedures by PwC*

In the following cases where the staff identified departures from PCAOB standards, PwC performed additional audit procedures as a result of the staff identifying the deficiencies.

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<sup>6/</sup> In the same Form 10-Q, the issuer recorded a reserve for probable losses associated with the lease guarantees.

(1) As described in Section I.B.1.b(2) above, the existence of leases that had been guaranteed by an issuer and transferred as part of the sale of an operating unit was not disclosed as required by GAAP. The staff's review of the sale agreement (included in the firm's work papers) revealed information that the staff believed should have raised significant questions about the existence of the lease guarantees, including specific references to two significant guarantees in a disclosure schedule, and a provision that the purchaser would make certain efforts to have the seller released from obligations under guarantees set forth on certain schedules, including schedules of leases. The staff concluded that the engagement team, through a careful consideration of the contents of the transaction documents, should have obtained an appropriate understanding of the sale and performed additional audit procedures to satisfy itself that the contingent lease obligations had been extinguished or, if not extinguished, appropriately recorded or disclosed in financial statements prior to the third quarter of 2003.

Further, the engagement partner had not documented the basis for his conclusions that a restatement (either to record losses or to make additional disclosure) of prior financial statements was not necessary. PwC acknowledged to the staff that, in connection with its review of the third quarter Form 10-Q, it should have documented its consideration of the need for restatement of previously issued financial statements. The firm has since prepared such documentation, contemporaneously dated,<sup>7/</sup> and included it in the 2003 third quarter work papers.

(2) One issuer's financial statements included a deferred income tax asset related to a net operating loss carryforward. SFAS No. 109, requires recognition of a valuation allowance if it is more likely than not that some or all of a deferred tax asset will not be realized. The issuer had provided no valuation allowance despite the fact that the issuer had incurred a net loss for that year and the preceding year. The staff observed that the 2002 work papers did not document the basis for a conclusion that the deferred income tax asset did not require a valuation allowance. After the staff brought this to the attention of the engagement partner, the engagement partner prepared a memorandum, dated November 5, 2003, intended to support the engagement team's testing in this area. The memorandum did not, however, include a summary of the engagement team's audit procedures in this area.

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<sup>7/</sup> As used in this report, any reference to "contemporaneous" dating of a document means that the document is dated contemporaneous with the creation of the document.

After reviewing the memorandum, the staff indicated that the engagement team's documented testing of the issuer's net deferred tax asset balance was insufficient to conclude that it was more likely than not that a valuation allowance was not required at December 31, 2002. In response, the firm required the engagement team to perform audit procedures on the net deferred tax asset balance, and to consult with an accounting consultant in the firm's national office.

The firm's response acknowledged that the engagement team's testing of the issuer's net deferred tax asset balance in the 2002 work papers was insufficient. The firm provided the staff with a revised memorandum and a spreadsheet that included detailed projections of future taxable income sufficient to support the realization of the deferred tax asset before its expiration. In the revised memorandum, the engagement team concluded that no valuation allowance was required at December 31, 2002 because the positive evidence (*i.e.*, the evidence supporting no valuation allowance) outweighed the negative evidence. The revised memorandum also described the audit procedures the engagement team had performed on the issuer's projections.

*b. Additional Departures Other than Documentation Deficiencies*

The staff identified various other departures from PCAOB standards and/or the firm's own quality control policies that involved deficiencies other than documentation deficiencies. In each case, the staff concluded that the circumstances overall did not warrant a conclusion that the financial statements had not been audited in accordance with PCAOB standards.<sup>8/</sup>

(1) The staff observed three engagements where the engagement team identified a financial statement misstatement in excess of the engagement team's documented *de minimus* posting threshold but failed to include these misstatements on the Summary of Unadjusted Audit Differences (SUD).<sup>9/</sup> In each instance, by not including the identified misstatements, the engagement team may not have properly evaluated whether the financial statements were

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<sup>8/</sup> To reach this conclusion, the staff considered the inherent risk of misstatement of the financial statement component at issue and of the relevant audit assertions, the materiality of these items, the impact of any relevant internal controls of the issuer, and the extent and nature of other relevant substantive procedures that the audit team carried out.

<sup>9/</sup> The SUD reflects proposed audit differences that are not corrected by the issuer.

presented fairly in all material respects. A further result was that these misstatements were not communicated to the audit committee, nor was a representation obtained from management that such misstatements were immaterial, as are required by PCAOB standards. The engagement teams agreed with the staff's comment. Two of the engagement teams prepared a revised SUD that included the identified misstatements, evaluated the revised SUD and concluded that the misstatements were immaterial, both individually and in the aggregate. With respect to the third instance, the misstatement related to a balance sheet reclassification, while the *de minimus* posting threshold related only to misstatements of income. The engagement team evaluated the misstatement and concluded that it was not material, individually or in the aggregate, to the financial statements. The engagement team also stated that the issuer corrected the misclassification in 2003.

(2) In one instance, the engagement team used non-statistical audit sampling in testing the valuation of the materials inventory balance. The engagement team did not, however, project a known misstatement to the untested portion of the materials inventory balance. Such projection is necessary to evaluate whether the aggregate misstatement, which is the known misstatement plus the projected misstatement, exceeded the SUD *de minimus* posting threshold. In response to this comment, the engagement team projected the known misstatement to the untested portion of the materials inventory balance and determined that the aggregate misstatement exceeded the SUD *de minimus* posting threshold. Accordingly, the engagement team prepared a revised SUD that includes the aggregate misstatement identified by this test, evaluated the revised SUD and concluded that the misstatements are immaterial to the audited financial statements. In addition, the engagement team prepared a memorandum documenting the projection and the conclusions regarding materiality. The engagement team further stated that it would inform the issuer's audit committee and management of the addition to the SUD.

(3) PwC policy generally requires the archiving of electronic work papers by the later of six months after the end of the period audited or three months after the report date. PwC also employs a system designed to archive work papers automatically at that time. On two engagements, the staff observed that the work papers had not been archived within the time period required by firm policy. One engagement team told the staff that the work papers had not been archived because the engagement team was continuing to work on certain matters that required access to the year-end file (though the staff is not aware of any way in which archiving the work papers would have limited the engagement team's access to the work papers for the purposes described). Both engagement teams had avoided the firm's automatic archiving by altering the actual report date in the firm's electronic work paper system.

Failure to comply with the firm's archiving policy creates the risk that work papers may be inappropriately altered following the completion of the audit. In the case of one of the two engagements, the staff's review of the work paper file at different points in its evolution suggested to the staff that certain audit procedures eventually documented in the work papers may not have been completed before the issuance of the audit report, though PwC stated to the staff that this was not the case.

(4) The staff found that, as part of testing the merchandise inventory balance for one issuer, the engagement team observed physical inventory procedures conducted by the issuer at certain locations. The engagement team explained that the audit strategy is to test and rely on controls that the issuer has in place over the inventory, including the use of a third-party inventory-taking services company that had been performing independent inventory count procedures at the issuer's locations throughout the year. The engagement team did not compare the amounts reported by the third-party inventory services company with the issuer's records for any locations not visited by the engagement team. The staff expressed its view that such a procedure would have been appropriate as a test of the issuer's controls. In response, the engagement team expressed its view that its testing of controls over the physical inventory, combined with certain substantive analytical procedures over inventories, was adequate. The engagement team told the staff that, as part of the 2003 audit, it would confirm amounts reported by third-party inventory-taking services for certain locations not visited by the firm and would agree the amounts to the issuer's records.

(5) In its inspection of the audit of one issuer, the staff found that the engagement team had not requested confirmation of rebates receivable from the issuer's vendors. According to the work papers, the engagement team concluded that certain procedures, including analytical procedures and subsequent cash testing, were sufficient to reduce audit risk to an acceptably low level without requesting confirmations. The staff concluded that confirmations would have been appropriate, particularly in light of the nature and size of the rebates receivable and given the limited evidence obtained from analytical procedures and subsequent cash collections. The engagement team responded by describing in more detail the tests of controls, analytical procedures and subsequent cash receipts testing that it had performed. It also noted that the issuer has not historically had problems collecting its rebates receivable. While taking the position that relevant PCAOB standards do not require confirmation of rebates receivable, the engagement team stated that, in connection with the 2003 audit, it would confirm significant rebate receivable balances.

(6) In one instance, the engagement team documented that it had used a strategy of "high controls reliance" for the audit that, in accordance with the firm's audit methodology, would require evaluation of the design and testing of the operating effectiveness of relevant internal controls in order to reduce the amount of substantive audit work required. The staff's review of the General Computer Controls section of the audit work papers revealed that the engagement team's testing of the issuer's general computer controls consisted primarily of the evaluation of a report on controls placed in operation and tests of operating effectiveness issued by another accounting firm (the "service auditor") covering the six-month period ended April 30, 2002.

Based on initial discussions with the engagement team, the staff found that, with respect to the period from May 1, 2002, through December 31, 2002, (the issuer's year-end), the principal audit procedures performed were inquiries of management. Under Statement on Auditing Standards No. 94 ("SAS 94"), *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, inquiry alone generally does not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control. It therefore appeared that the operating effectiveness of the issuer's general computer controls was not tested for the eight-month period ended December 31, 2002. The staff concluded that the engagement team should have performed, at a minimum, tests of controls related to the issuer's general computer controls for the untested eight-month period to support its "high controls reliance" strategy.

Moreover, the staff was unable to determine from the service auditor's report whether the testing performed by the service auditor even covered those general computer controls that related specifically to the issuer's accounting and financial reporting systems. The staff concluded that the engagement team should have obtained written evidence from the service auditor that specifically addresses whether its testing covers the issuer's general computer controls over accounting and financial reporting systems. In addition, the staff concluded that any conclusions with respect to reliance on the service auditor's report, and the appropriate basis thereof, should have been documented or evidenced in the work papers.

In response to the staff's concerns, the engagement team enlisted the assistance of a director from the firm's National Risk Management group, as well as a partner from the firm's Systems and Process Assurance practice, to review the matter. While the engagement team continued to maintain that it had executed a "high controls reliance" strategy in accordance with firm policy and that its reliance on the service auditor's report was appropriate, the consultants stated that they did not agree that a "high controls reliance" strategy had been

executed. Both the engagement team and the consultants, however, took the position that the actual audit procedures performed by the engagement team were sufficient to comply with PCAOB standards and firm policy.

The engagement team subsequently identified for the staff additional audit procedures that had been performed by the engagement team related to the issuer's general computer controls, which were documented in the Application Controls section of the work papers, in addition to the documented reliance on the service auditor's report, which was documented in the General Controls section of the work papers. The firm acknowledged that the *"testing of general controls is not clearly documented in our [the engagement team's] audit file"* and as a result the engagement team prepared a contemporaneously dated memorandum and supporting schedules that better evidence the engagement team's audit procedures that were performed related to the issuer's general computer controls. In addition, the firm subsequently orally confirmed the appropriateness of its reliance on the service auditor's report directly with the service auditor. The firm also contemporaneously documented the basis for the engagement team's reliance on the service auditor's report, and the firm has stated that if the engagement team plans to place reliance on the service auditor's report in future engagements, the engagement team will request that the issuer obtain written representation from the service auditor regarding the applicability of the report to the client's accounting and financial reporting systems.

(7) On one engagement, there were six instances where the engagement team received the independence confirmations from participating non-U.S. PwC affiliated firms after both the U.S. team and the non-U.S. PwC affiliated firm had commenced procedures on the audit under inspection. In five of those instances, the confirmations were received after the date of the audit report, but before its issuance. The staff observed that this appeared to violate PwC's policy that non-U.S. PwC affiliated firms should confirm their independence before commencing their portion of an engagement. The engagement team agreed with the staff's comment and stated that it had made numerous requests of the non-U.S. PwC affiliated firms to return their independence forms on a timely basis. The staff confirmed that all necessary independence forms were received before the release of the report and the issuer's filing of the Form 10-K. The engagement team stated that it will continue to emphasize to non-U.S. affiliates the importance of receiving these confirmations in a timely fashion.

(8) The work papers for one engagement document that the engagement team enlisted the assistance of the firm's Actuarial and Insurance Management Solutions ("AIMS") group to assess the reasonableness of the

issuer's self-insurance reserves. The AIMS group estimated that the reserve for one category of costs appeared to be overstated. The engagement team included the difference between that AIMS estimate and the issuer's estimate (in this case, a potential increase in reported income) on the engagement team's SUD and discussed the difference with the issuer's management and audit committee.

The AIMS group estimated that the reserve for a second category of costs appeared to be understated. With respect to the reserve for this second category of costs, however, the engagement team did not include the difference between the estimates (a potential decrease in reported income) on the SUD. The engagement team documented its view that the difference in these estimates was due to the AIMS group applying industry averages to the issuer's claims data in order to estimate the reserve, whereas the issuer had used its actual prior history. The engagement team did not, however, document or perform an analysis to support whether the asserted differences between the issuer's prior history and the industry averages actually accounted for the difference in the estimated reserve. In addition, according to the AIMS group's summary memorandum, the issuer's claims data provided to it had not been audited for accuracy. Moreover, in the staff's view, the engagement team did not perform sufficient testing on that underlying claims data, and the work papers lacked sufficient documentation of the engagement team's knowledge of the self-insurance claims administration process and the issuer's process for estimating the related reserves. Finally, in the staff's view, the work papers did not reflect that the engagement team had taken appropriate steps to evaluate the reasonableness of the estimates.

In response to the staff's concerns, the firm stated, among other things, that the engagement team's approach in this area was to review and test the process used by management to develop the estimate, and the firm took the position that this approach was consistent with PCAOB standards. After the staff pointed out that the work papers did not appear to document any such review and testing of the issuer's process, the firm revised its response to acknowledge the documentation deficiency, but also took the position that the procedures actually documented were sufficient and appropriate in light of the significance of the reserves. The firm noted that, if this area had been more significant, the firm would have treated the matter differently and documented the issuer's processes and controls over this account balance.<sup>10/</sup>

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<sup>10/</sup> The staff observed that the Critical Accounting Policy section of the issuer's 2002 Form 10-K and the Notes to the issuer's financial statements describe the estimate as "significant," and that PwC's work papers identify this area as "high risk."

The staff continues to hold the view that, at a minimum, the work papers do not document sufficient audit procedures with respect to the reserve recorded by the issuer for the second category of costs. In the absence of documentation, and in light of the firm's conflicting responses to the staff's inquiries, the staff was unable to conclude whether sufficient audit procedures were performed with respect to that reserve.

*c. Additional Departures Concerning Documentation*

The staff noted additional documentation deficiencies in the engagements reviewed. With respect to these deficiencies, the staff concluded either that other evidence allowed the staff to reach the same conclusions that the engagement team had articulated, or that, despite a lack of other evidence, those deficiencies did not render the audit as a whole deficient.<sup>11/</sup>

(1) One issuer's financial statements included an environmental remediation receivable, reflecting money owed to the issuer by government entities for certain environmental remediation costs, including government entities with significant backlogs in paying such claims. Statement of Position 96-1, *Environmental Remediation Liabilities* ("SOP 96-1"), allows the establishment of an asset relating to potential recovery from governmental funds only when realization of the claim for recovery is deemed probable. Except for a few notes on a copy of the issuer's cash flow models (not included in the work paper file) and a "critical matter" memorandum, there was no documentation in PwC's work papers of the audit procedures performed, as of December 31, 2002, to determine the collectibility of this receivable. The staff expressed concern about the lack of documentation of the engagement team's audit procedures on the receivable and the engagement team's conclusion regarding the probability of its collection. In response, the engagement team added documentation to the 2002 work papers to support its conclusions regarding the collectibility of the receivable balance. The engagement team also documented how it had used the issuer's cash flow models and other information in this assessment.

(2) The staff observed various other instances of documentation deficiencies in the engagements reviewed. In almost every case, after the staff brought the matter to the attention of the engagement team, the engagement team prepared supplemental documentation to alleviate the deficiency.

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<sup>11/</sup> The staff reached that conclusion based on consideration of the inherent risk of misstatement and the materiality of the financial statement component at issue, combined with the extent and nature of other related internal control and substantive audit procedures carried out.

**C. Certain General Observations**

As intended, the 2003 limited inspection of PwC has provided an important foundation for more far-reaching inspections of the firm. Within the seven functional areas, the Board has identified issues that will warrant more probing scrutiny in a full-scale inspection, and examination of these issues will continue in annual inspections of PwC. These issues, however, do not lend themselves to a thorough critique on the basis of a single, limited inspection.

As a general matter, the Board is encouraged by indications that the mere anticipation of a review of the firm's practices may already have had a positive effect on the firm, as the staff found a number of recent changes to firm policies and procedures relating to some of the seven functional areas. The Board is also encouraged by indications that the firm understands that the Act calls for a renewed and heightened focus on audit quality, and that the firm has been working to develop an increased emphasis on audit quality. In addition, the firm was cooperative and responsive with respect to questions raised by the staff about compliance with auditing standards and accounting principles.

Even so, the Board intends to maintain a critical eye, through the inspection process, on the development of the firm's initiatives, and their impact on audit quality, over time. The limited inspection has revealed issues that Board inspectors will probe more deeply in future inspections and that the Board will expect the firm to address as the Board refines its understanding of the firm's practices.

**END OF PART I**

**PART II OF THIS REPORT IS NONPUBLIC  
AND IS OMITTED FROM THIS PUBLIC DOCUMENT**

### **PART III**

#### **RESPONSE OF PWC TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided PwC an opportunity to review and comment on a draft of this report. PwC provided a written response.

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. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change made to the report before the Board finalizes the 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. In any version of this report that the Board makes publicly available, any portions of the firm's response that address nonpublic portions of the report are omitted.

July 22, 2004

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

**Re: Response to Draft Report on 2003 Limited Inspection of  
PricewaterhouseCoopers LLP**

Dear Mr. Diacont:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB's) draft report on its 2003 limited inspection of the U.S. firm of PricewaterhouseCoopers LLP.

We strongly believe in and support the PCAOB's mission. As we have stated many times, we share with the PCAOB the goals of restoring investor confidence and public trust in our profession.

To further those objectives, we also support the PCAOB's inspection process. Our full and open cooperation and responsiveness to the Board and its staff, as noted in the draft report, demonstrates our dedication and commitment to the process. While we believe that our audit quality is high, we expect and welcome fair and constructive observations of our policies, procedures and their implementation, and take seriously the Board's observations included in the draft report. We are always focused on continual improvement, and the Board's observations are very helpful to us in this regard.

We also believe strongly in the intelligence, integrity and professionalism of our people and our collective commitment to audit quality.

We are concerned, however, that the draft report – by concentrating on a relatively few number of identified issues – does not adequately portray the overall high level of audit quality that exists within our firm. While we acknowledge the limited nature of the 2003 inspections procedures, which make it difficult if not impossible for the

Board to reach firm conclusions about all aspects of our firm's performance, we are concerned that readers of this report will not have a complete picture of our audit quality.

A team from our national office accompanied the Inspections staff throughout its 2003 efforts, to ensure that the Inspections staff received all necessary logistical support, as well as to serve in a liaison role during the Inspections staff's field visits and in coordinating responses to issues raised by the Inspections staff. In every sense, our team lived through the four- to five-month inspection process along with the eight members of the Inspections staff, and this team is intimately familiar with the process and its results. Here's how our team would summarize the inspection:

- It was well planned and executed, and the staff was extremely professional in all of their dealings with us. The Inspections staff spent thousands of hours over the course of the inspection.
- As would be expected after any effort of that magnitude, a number of questions were raised that led to findings around the application of accounting and auditing standards and firm policies.
- For the thousands of transactions examined and the thousands of audit decisions made in the course of the sixteen audits reviewed in detail by the Inspections staff, the most significant findings were:
  - Instances where work was not fully documented on a timely basis, including two instances where the engagement team bypassed the firm's internal policies for document completion.
  - An instance where an engagement team inappropriately shortcut audit work around the tax provision.
  - An instance where the Board believed an engagement team did not adequately consider an issuer's disclosure around lease guarantees.
- In addition, unrelated to the Inspections staff's office reviews, there were three instances where we did not identify the issuer's incorrect application of GAAP relating to balance sheet classifications under EITF 95-22.

We accept those comments and acknowledge the issues raised by those findings.<sup>1</sup> We are working to address these items (please refer to Appendix 1 to this response letter), along with a host of other inputs we have that help us in our efforts to continually improve. However, we believe that the Board's findings must be put in context.

To that end, we note that, across all of the engagements that the staff touched in the course of its 2003 inspection, no issues were identified related to the accuracy of total assets, liabilities or equity, or to the accuracy of total revenues or net income, within the financial statements of any of those client engagements.

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<sup>1</sup> Certain of the Board's findings described in the draft report appear to us to be criticisms of the firm's quality control systems and, accordingly, should be subject to treatment under section 104(g)(2) of the Sarbanes-Oxley Act and PCAOB Rule 4009.

We also note that there is no “baseline assessment” of the firm’s audit quality, which was the Board’s stated objective for the 2003 inspection procedures.

Part II of the draft report describes some concerns about potential quality control defects that, under the Act and PCAOB rules, will be made public only if they are not addressed, to the satisfaction of the Board, within twelve months from the date of the final inspection report. In part because this is the first report the Board is issuing, but also because of our intention to be fully responsive, we would like to meet with members of the Board and its staff soon after the final report is issued so that we may ensure that we fully understand the potential quality control issues raised in Part II, as well as to discuss the Board’s expectations as to our response. Our goal would be to come to an understanding of the process through which we can satisfy the Board that the actions we are and will be taking are adequate to address the matters contained in the report.

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Quality is a strategic imperative for us. We have worked hard to set the right tone, in our messages to our people about standing firm on quality, our responsibility to the investing public and the important role we serve in the capital markets. We have embedded this in our infrastructure, where leaders at all levels across our industry/geography matrix are now responsible for and driving quality initiatives. And we are revisiting key internal processes, using Six Sigma process improvement specialists and tools.

In addition, we have significantly increased our investments in our people's training and development, highlighted by our Quality Lens series, which over thirty months has evolved from helping to manage cultural change around quality and critical behaviors to driving our key content learning through the very same “quality” lens. We have devoted more resources to our national technical group; Risk & Quality headcount is up more than a third over the last eighteen months – 150 partners, directors and managers helping our people and our clients manage the many new and complex accounting and auditing standards. And we've asked our partners to reconnect with our people at all levels, to support their development, and to instill pride in what we are accomplishing within our teams and throughout the firm.

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In Appendix 2 to this response letter, we set out a number of points that we offer to provide additional context and clarity to certain of the items described in the Draft Report. We encourage the Board to consider revisions to the final report so that it presents more clearly the issues raised during the 2003 inspection.

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions the Board or staff may have.

Sincerely,

**PricewaterhouseCoopers LLP**

## Appendix 1

In the body of our response letter, we summarize the significant findings of the 2003 inspection from the vantage point of our national office team that worked side-by-side with the Inspections staff throughout the course of the inspection process. Those findings encompass:

### Documentation and Wrap-up:

- Full and timely documentation of the work performed.
- Completing wrap-up procedures within prescribed parameters.

### Other Accounting and Auditing Issues:

- Appropriate audit work around a tax provision.
- Adequate consideration of an issuer's disclosure around lease guarantees.
- Adequate consideration of issuers' application of EITF 95-22.

The discussion that follows below provides examples of our ongoing efforts to address these issues.

### **Documentation and Wrap-up**

The evolution of our internal policies and procedures around documentation broadly, and around the timing of wrap-up and completion procedures more specifically, were the subject of two meetings we had with the Inspections staff after the staff completed its 2003 field visits and engagements reviews. In addition to answering the staff's questions, we walked the staff through how our policies and procedures evolved over the six years since the merger of our two legacy firms into PricewaterhouseCoopers LLP.

**Documentation.** In addition to the policy changes referred to above and periodic reminders to our partners and staff over the past two years, we continue to focus on the consistency of the quality of our documentation by, among other things, enhancing targeted training to highlight the documentation requirements at the same time and in the same context of our training around the basic accounting and auditing concepts; introducing practice aids on the appropriate focus on documentation and other key elements of the audit as work is wrapped up prior to report release; and providing guidance and training around the new regulatory requirements of the SEC, New York and California, as well as the PCAOB's new documentation standard.

Our broader emphasis here is on what we call "driving performance through documentation," moving away from templates and instead requiring comprehensive, start-from-scratch memoranda. This emphasis is also demonstrated by recent policy

changes enhancing guidance on documenting the nature and extent of substantive testing; around our national consulting protocols; and around each engagement team's audit committee communications plan.

**Wrap-up.** We recognized the broad scope of the accelerated wrap-up deadlines in New York, California and now in the PCAOB's documentation standard, as well as the Sarbanes-Oxley and SEC document retention rules. Given the breadth of these changed requirements, our approach was quite deliberate, starting in early 2003 with formulating and announcing appropriate policy changes, followed by comprehensive training around the requirements and new practice aids. We are currently in the process of testing the next version of our file maintenance systems that include edit checks and other tools to better facilitate and monitor compliance.

### **Other Accounting and Auditing Issues**

The issues identified by the staff around the auditing of a tax provision and the disclosure of lease guarantees are good examples of the types of performance issues that we identify in our own internal quality inspection program. Almost always, these are isolated issues within otherwise fine audits. Given their nature, our focus is to look closely for trends and themes that might indicate broader issues in applying the underlying accounting or auditing issues across any subset of our practice, and we then deal with those trends and themes through practice alerts, training, consultation requirements, practice aids and other means, as appropriate.

For example, in January 2004, in response to the issues raised by the staff, we issued a practice alert around EITF 95-22. In addition to reminding our partners and staff to watch closely for fact patterns within the scope of the EITF's consensus, this alert also announced a new requirement to consult with a subject matter expert in the national office whenever a client's revolving debt facility includes a lockbox feature.

## Appendix 2

Please note the following points that we offer to provide additional context and clarity to certain of the items described in Part I of the draft report.

(Part I.B, page 16) Based on our interaction with the staff around the six potential EITF 95-22 issues that they brought to our attention, we understand that staff members performed an extensive search of public filings in order to identify fact patterns in which EITF 95-22 was applicable but the issuer's balance sheet classification was potentially inappropriate. We assume that this effort encompassed hundreds of our issuer clients, if not more. We believe that additional context is important to a full understanding of your findings in this area.

(Part I.B.1.b (1), page 18) The engagement team maintained that the presentation of vendor rebates receivable within trade accounts receivable was at least acceptable within this industry but, in the spirit of cooperating and working in the public's interest, thought it made sense to bring the idea to the client. The client's view is that these are "trade receivables" and, accordingly, it has not changed the classification within its balance sheet. The client did, however, start disclosing the components of trade receivables in the footnote. We believe that the description of this matter in the draft report presents our willingness to discuss the idea with the client as a deficiency, a conclusion with which we disagree and which we believe to be at odds with the interaction between our engagement team and the staff at the time of the inspection.

(Part I.B.1.b (2), pages 18-19) We believe that it is important to note that neither we nor client management were aware of the lease guarantees. Furthermore, management had represented to us in connection with our audits of 2001 and 2002 that there were no material undisclosed items of this nature.

We continue to agree that the existence of the lease guarantees should have been disclosed. However, we believe that it is important to note that the missing disclosure would have been quite innocuous. As we demonstrated to the staff, the missing disclosure in the prior financial statements would merely have noted the existence of the guarantees and management's view – at the time of those prior financial statements – that there was no expectation of a material loss.

(Part I.B.2.a (1), page 19) We believe that it is also important to note that the sale transaction was audited in 2000 and reported upon by the predecessor auditor, and that client management had represented to us in connection with our 2001 and 2002 audits that there were no material undisclosed items of this nature. We believe that the staff's conclusions reflect the benefit of hindsight that neither the client nor the engagement team had, and that the presentation of this matter in the draft report reflects neither that benefit of hindsight nor the necessary context to provide a reader of your report with a fair picture of the matter.

(Part I.B.2.b (4), page 23) The engagement team was able to satisfy the staff that the audit procedures performed were adequate but, in the spirit of cooperating and working in the public's interest, agreed that it was worth pursuing the staff's suggestion to, in future years, tie out a sample of items counted by the third-party counters at some of the locations the team did not visit. We believe that the description of this matter in the draft report leads a reader to conclude that our willingness to pursue this suggestion is a concession on the adequacy of the work, a conclusion with which we disagree and which we believe to be at odds with the interaction between our engagement team and the staff at the time of the inspection.

(Part I.B.2.b (5), pages 23-24) We believe that the description of this matter in the draft report leads a reader to conclude that the engagement team's agreement to pursue the staff's suggestion is a concession on the adequacy of the work. The engagement team's willingness to pursue this suggestion was in the spirit of cooperating and working in the public's interest, and we disagree with any inference that the procedures performed were inadequate. We also believe that any such inference is at odds with the interaction between our engagement team and the staff at the time of the inspection.

(Part I.B.2.b (8), page 26) The description of this matter in the draft report does not appropriately distinguish the different approaches taken on the two different self-insurance reserves. The client had engaged a third-party actuary in connection with its analysis of only one of these two reserves. Client management relied on the third-party actuary in this case, and had its own processes and procedures to develop its estimate of loss reserves in the second case. Firm policy in this area outlines two acceptable audit approaches in these circumstances; a team can either review and test management's process or develop its own independent expectation. Policy further requires that, if a loss reserve specialist isn't used by management, an independent expectation must be developed. That means that the use of our internal actuaries, AIMS, in connection with the reserve for which management had not used a third-party actuary, was required under policy. Furthermore, the AIMS estimate was the only evidence we had about that reserve. Conversely, for the reserve for which management had used a third-party actuary, use of AIMS was not required. For this reserve, the audit evidence was obtained through review and testing of management's processes and procedures; the use of AIMS was optional and was a reasonableness test on which little or no reliance was placed.