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**Report on**

**2007 Inspection of Deloitte & Touche LLP**

**Issued by the**

**Public Company Accounting Oversight Board**

**May 19, 2008**

**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. 104-2008-070A  
(Includes portions of Part II and Appendix C of the full report  
that were not included in PCAOB Release No. 104-2008-070)



### **Preface to Reports Concerning Annually Inspected Firms**

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("PCAOB" or "the Board") to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers. The Board's report on any such inspection includes this preface to provide context for information in the public portion of the report.

A Board inspection includes, among other things, a review of selected audits of financial statements and of internal control over financial reporting. If the Board inspection team identifies deficiencies in those audits, it alerts the firm to the deficiencies during the inspection process. Deficiencies that exceed a certain significance threshold are also summarized in the public portion of the Board's inspection report. The Board encourages readers to bear in mind two points concerning those reported deficiencies.

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take, action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Second, the Board cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in



that year. Such weaknesses may emerge in varying degrees at different firms in different years.

During 2007, the Board's inspection process for annually inspected firms addressed the third year of implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"). As described in Appendix B to this report, this process occurred at three levels: (1) meetings with firm leadership, (2) a review of the Firm's methodology and tools, and (3) inspections of certain audits of accelerated filers. The reviews of audits included reviews conducted before the regular practice office field work to follow up on certain matters identified in the previous year's inspection, and reviews conducted during the regular practice office field work of certain audits selected by the inspection team. In general, the Board's inspection teams observed that the firms continued to make improvements in their audits of internal control over financial reporting, and that firms were preparing to implement Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.



### 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 supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



## 2007 INSPECTION OF DELOITTE & TOUCHE LLP

In 2007, the Board conducted an inspection of Deloitte & Touche LLP ("Deloitte" or "the Firm"). 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, Appendix B, and portions of Appendix C. Appendix B provides an overview of the inspection process. Appendix C includes the Firm's comments, if any, 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 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.

<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 inspection team") performed an inspection of the Firm from March 2007 through November 2007. The inspection team performed field work at the Firm's National Office and at 18 of its approximately 74 U.S. practice offices.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.<sup>3/</sup> To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system. Appendix B to this report provides a description of the steps the inspection team took with respect to the review of audits of financial statements and of internal control over financial reporting and the review of eight functional areas related to quality control.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.<sup>4/</sup> It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

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<sup>3/</sup> This focus necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

<sup>4/</sup> When the Board becomes aware 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 GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of selected audits of financial statements and of internal control over financial reporting performed by the Firm. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process. In certain cases, the review of an audit of an accelerated filer included a review of aspects of both the Firm's audit of financial statements and its audit of internal control over financial reporting ("ICFR").

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies.<sup>5/</sup> Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the Firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3") 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.<sup>6/</sup> For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the

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<sup>5/</sup> The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

<sup>6/</sup> See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

deficiencies to the firm's present ability to support its previously expressed opinions,<sup>7/</sup> and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers, and in some instances, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.<sup>8/</sup>

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis.

#### Issuer A

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The issuer incorrectly concluded that interest rate swaps qualified for hedge accounting using the short-cut method in Statement of Financial Accounting Standards ("SFAS")

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<sup>7/</sup> See AU 390, *Consideration of Omitted Procedures After the Report Date*, AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T), and PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("AS No. 2"), ¶ 197.

<sup>8/</sup> The Board inspection process generally did not include review of such additional procedures or documentation, or of such revised accounting, although future Board inspections of the Firm may, as appropriate, include further review of any of these matters.



No. 133, *Accounting For Derivative Instruments and Hedging Activities* ("SFAS No. 133").<sup>9/</sup>

- The issuer had income tax net operating loss carryforwards for which there was no valuation allowance. The Firm failed to evaluate the reasonableness of certain significant assumptions that the issuer had used in its forecast of taxable income during the carryforward period. In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the issuer's tax planning strategies that related to the issuer's assertion that it was more likely than not that the net operating loss carryforwards would be realized were prudent and feasible.

#### Issuer B

The Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The issuer incorrectly concluded that interest rate swaps qualified for hedge accounting using the short-cut method in SFAS No. 133.<sup>10/</sup>

#### Issuer C

The issuer had a contingent liability and it deemed the likelihood of an unfavorable outcome not to be probable. While the Firm obtained responses to its inquiries of the issuer's lawyers, the responses did not include an evaluation from the outside counsel handling the matter regarding the probability of an unfavorable outcome, and the Firm failed to perform additional procedures to evaluate this contingency.

#### Issuer D

In this audit, the issuer had substantial income tax net operating loss carryforwards for which a valuation allowance had been recorded. During 2006, the issuer reduced its valuation allowance after concluding it was more likely than not that

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<sup>9/</sup> The issuer has restated its financial statements related to the matter discussed here.

<sup>10/</sup> The issuer has restated its financial statements related to the matter discussed here.

the net operating loss carryforwards would be realized. The Firm failed to evaluate certain of the significant assumptions that the issuer had used in its forecasts of significant increases in pre-tax income during a portion of the carryforward period to support its assertion that it was more likely than not that the net operating loss carryforwards would be realized.

#### Issuer E

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to perform sufficient procedures to assess the valuation of certain of the issuer's privately-issued mortgage-backed security holdings, which the Firm assessed as possessing "low inherent risk" with respect to valuation, in that, in some instances, the Firm's testing relied primarily on pricing information that it had obtained from the issuer, and, in some instances, it failed to obtain an understanding of the methods and assumptions outside parties had used to develop the estimates of fair value.
- The Firm failed to perform sufficient procedures to assess the valuation of the issuer's mortgage loans held for sale. The Firm selected a sample of loans in order to test the valuation assertion. This sample, however, was not representative of the portfolio, as it included only conforming loans, which represented 45 percent of the portfolio and constituted the more easily priced loans in the portfolio. In addition, the Firm failed to assess whether the issuer's credit-based valuation approach for delinquent loans held for sale was appropriate given that the approach did not consider changing interest rates and market demand.
- The Firm failed to evaluate whether the issuer's use of hedge accounting for interest rate swaps was appropriate. Specifically, the Firm failed to obtain evidence to evaluate management's representation that at inception, the hedge was expected to be highly effective during its term. The Firm further failed to perform procedures to determine whether the issuer had contemporaneously prepared appropriate hedge documentation in accordance with SFAS No. 133.

- The issuer calculated its allowance for loan losses by applying specified percentages to two categories of delinquent loans, determined by the term of the delinquency. The Firm failed to evaluate whether this method was appropriate in light of the fact that the method did not differentiate the loans by type, maturity, or other relevant characteristics, nor did it include consideration of qualitative or environmental factors.
- The issuer transferred loans to intermediaries prior to their sales to the ultimate investors, and portions of the consideration to be paid to the issuer by the intermediaries were withheld pending the final sales. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had analyzed all the terms of the arrangements between the intermediaries and the issuer in order to evaluate what effect these terms may have had on the accounting for the transfer of these loans.

#### Issuer F

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The issuer used interest-rate swaps to hedge the risk associated with future sources of financing. The Firm failed to sufficiently test whether the issuer's application of hedge accounting to these transactions complied with SFAS No. 133. Specifically, the Firm failed to assess whether the issuer had identified hedged forecasted transactions with sufficient specificity so that when a transaction occurred, it was clear whether that transaction was or was not the hedged transaction. In addition, the Firm failed to sufficiently evaluate whether forecasted transactions that the issuer had grouped together for purposes of determining hedge effectiveness shared the same risk exposure. For example, the Firm failed to test the data that the issuer had used in determining hedge effectiveness.
- The Firm relied on information that the issuer had used in concluding that certain available-for-sale securities were not "other-than-temporarily" impaired and did not obtain corroboration of that information. In addition, the Firm failed to evaluate the issuer's representation that it had the intent and the ability to hold these securities until their values recovered.

- The Firm did not address significant differences between the amounts the issuer had recorded for interest rate swaps and those the Firm had calculated while testing the valuation of those financial instruments.<sup>11/</sup>

#### Issuer G

The Firm failed to test the data it used in its analytical procedure regarding additions to a significant intangible asset, and it did not evaluate the reasonableness of the assumptions that the issuer had used in its impairment analysis for this asset. The Firm also failed to evaluate the reasonableness of the assumptions and test the accuracy of the data that the issuer had used to calculate a severance liability.

#### Issuers H and I

In these audits, the Firm failed to sufficiently assess the appropriateness of the issuers' methodology to value certain long-term derivative contracts in that it failed to test certain assumptions that the issuers had used in their calculations of the fair value of those derivative contracts.

#### B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies, and procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following eight functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) policies and procedures for staffing audits; and (8) the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. issuer audit clients. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of

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<sup>11/</sup> During the inspection, the Firm determined that there had been an error in the formulas it had used in its testing of the fair values of these financial instruments, and that there were not in fact significant differences between its calculation of the fair values and those calculated by the issuer.

this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED  
FROM THIS PUBLIC DOCUMENT

## PART II

### ISSUES RELATED TO QUALITY CONTROLS

This Part II describes the Board's concerns about potential defects in the Firm's quality control system. Assessment of a firm's quality control system rests both on review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements. On the basis of the information reported by the inspection team, the Board has the following concerns about aspects of the Firm's system of quality control.<sup>12/</sup>

#### A. Audit Performance

A firm's system of quality control should provide reasonable assurance that the firm's audit work will meet professional standards and regulatory requirements. Not every deficiency in an audit indicates that a firm's quality control system is insufficient to provide that assurance, and this report does not discuss every auditing deficiency observed by the inspection team. On the other hand, some deficiencies, or repeated instances of a similar deficiency, may indicate a potentially significant defect in a firm's quality control system even if the deficiency has not resulted in an insufficiently supported audit opinion. As described below, some deficiencies reported by the inspection team do suggest that the Firm's system of quality control may in some respects fail to provide sufficient assurance that the Firm's audit work will meet applicable standards and requirements.

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<sup>12/</sup> This report's description of quality control issues is based on the inspection team's observations during the inspection field work, which concluded in November 2007. Any changes or improvements that the Firm may have made in its system of quality control since that time are not reflected in this report, but will be taken into account by the Board during the 12-month remediation process following the issuance of this report.

1. Specific Categories of Deficiencies

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b. Management Estimates

The engagement reviews provide cause for concern that the Firm's system of quality control may not do enough to assure that the Firm performs appropriate procedures to audit significant estimates, including evaluating management's assumptions and testing the data supporting the estimates. In addition to seven engagements<sup>13/</sup> described in Part I.A, the inspection team identified eight engagements<sup>14/</sup> (two of which are also discussed in Part I.A with respect to different estimates) with deficiencies in the Firm's testing of management estimates. Specifically -

- One issuer<sup>15/</sup> reduced the period for amortizing deferred revenue, which resulted in an increase in earnings. Although the Firm considered the issuer's analysis of the data underlying the change, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the conditions giving rise to the change in the amortization period.
- The issuer<sup>16/</sup> accrued its estimated state income tax contingent liabilities based on the likelihood that the tax authorities would perform audits of the issuer's filings rather than on the sustainability of the issuer's tax position. The Firm failed to challenge the issuer's approach to accruing its tax contingent liabilities and the assumptions the issuer had used in determining its accruals.

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<sup>13/</sup> Issuers A, D, E, F, G, H, and I

<sup>14/</sup> Issuers F, H, J, K, L, M, N, and O

<sup>15/</sup> Issuer J

<sup>16/</sup> Issuer K



- The Firm failed in two engagements,<sup>17/</sup> in addition to one engagement<sup>18/</sup> described in Part I.A, to evaluate the reasonableness of certain assumptions or test the data that the issuers had used in the valuation models that were the bases for their asset impairment tests.
- In three engagements,<sup>19/</sup> there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of certain assumptions or tested the data the issuers had used to value purchased intangible assets or to determine the useful lives of such assets.
- In one engagement,<sup>20/</sup> in addition to the deficiencies discussed in Part I.A, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of the issuer's assumptions in its cash flow forecasts that the issuer had used as the basis for recording interest income and determining whether investments were impaired.

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d. Income Taxes

The engagement reviews provide cause for concern about the effectiveness of the Firm's quality controls with respect to the audit procedures performed on income tax balances. The inspection team identified two engagements<sup>21/</sup> with deficiencies in this

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<sup>17/</sup> Issuers L and M

<sup>18/</sup> Issuer G

<sup>19/</sup> Issuers H, N, and O

<sup>20/</sup> Issuer F

<sup>21/</sup> Issuers H and Q

area.<sup>22/</sup> In one engagement,<sup>23/</sup> the Firm failed to obtain from the issuer sufficiently detailed information to allow it to test certain significant components of the issuer's deferred tax balances. In the other engagement,<sup>24/</sup> there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested certain significant components of the issuer's income tax provision, including the comparison of the prior year's tax returns to the prior year's tax provision. Also in this engagement, the engagement team was aware of the issuer's failure, for four years, to record in its general ledger a deferred tax asset and related valuation allowance, as described in Appendix A.

e. Use of the Work of Specialists

The engagement reviews provide cause for concern about the effectiveness of the Firm's quality controls with respect to the use of the work of specialists. The inspection team identified six engagements<sup>25/</sup> where there were deficiencies in the procedures relating to the use of the work of specialists. These deficiencies included five engagements<sup>26/</sup> where there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested certain data or assumptions that the issuer had provided to the specialist (beyond, in one instance,<sup>27/</sup> inquiry of management). In the sixth engagement,<sup>28/</sup> as part of their tests of the issuer's annual goodwill impairment test, the Firm's internal valuation specialists performed various sensitivity analyses to resolve concerns the specialists had raised regarding the issuer's

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<sup>22/</sup> In addition, the deficiencies described in Part I.A for Issuers A and D, which are referenced in Part II.A.1.b, above, related to the Firm's auditing of income tax balances.

<sup>23/</sup> Issuer H

<sup>24/</sup> Issuer Q

<sup>25/</sup> Issuers K, N, R, S, T, and U

<sup>26/</sup> Issuers K, N, R, T, and U

<sup>27/</sup> Issuer T

<sup>28/</sup> Issuer S

method for evaluating goodwill. For some of the issuer's reporting units, the sensitivity analyses indicated the fair value of the unit might be considerably lower, or considerably higher, than the unit's carrying value. The Firm failed to perform further, more precise sensitivity analyses, or other procedures, to determine whether the goodwill associated with these units was impaired.

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h. Reliance on Data, Reports, and Internal Controls

The engagement reviews provide cause for concern about the effectiveness of the Firm's quality controls with respect to reliance on data, reports, and internal controls. The inspection team identified four engagements<sup>29/</sup> with deficiencies in this area. In two engagements,<sup>30/</sup> the Firm relied on certain information technology general controls to establish the validity of the system-generated reports that it used in its substantive testing. Although the Firm tested some information technology general controls, it did not test certain of the controls necessary to assure the accuracy and completeness of the system-generated reports. In one other engagement,<sup>31/</sup> the Firm failed to test the completeness and accuracy of certain data that had been downloaded from a database and used to calculate gains on certain sales. In the fourth engagement,<sup>32/</sup> the Firm relied on controls operating at service organizations, but there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained service auditors' reports or performed other procedures to be able to rely on the controls at the service organization.

2. General Observations Concerning Audit Performance

The nature and number of the reported deficiencies identified by the inspection team (including, in nine of the 61 engagements reviewed, the Firm's failure to obtain

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<sup>29/</sup> Issuers P, X, Y, and AA

<sup>30/</sup> Issuers P and AA

<sup>31/</sup> Issuer Y

<sup>32/</sup> Issuer X

sufficient competent evidential matter, at the time it issued its audit report, to support its audit opinion) suggest that important issues may exist regarding:<sup>33/</sup>

- The design, adequacy, clarity, communication, and implementation of the Firm's audit methodology and other audit policies, including a possible need to require more thorough auditing of material transactions and management's estimates;
- The sufficiency of the Firm's emphasis on the critical need to exercise due care and professional skepticism when performing audits;
- The Firm's supervision and review activities to ensure that the audit is performed thoroughly and with due care;
- The enforcement, through appropriate monitoring and disciplinary activities, of compliance with the Firm's policies and procedures; and
- The quality, delivery, relevance, and timeliness of the Firm's training programs for audit personnel.

Some of these quality control issues are discussed further below.

The inspection results provide cause for concern that the Firm's system of quality control may not do enough to assure that accounting and auditing issues are evaluated with the objectivity that is contemplated in the auditing standards. In too many instances, the inspection team observed that the engagement team's support for significant areas of the audit consisted of management's views or the results of inquiries of management.<sup>34/</sup> The Firm's apparent failure to appropriately challenge management's representations occurred in numerous areas, including when the Firm evaluated management's estimates, considered the valuation of investment securities,

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<sup>33/</sup> For example, the Firm's system of quality control may not do enough to assure that the Firm identifies and appropriately addresses its audit clients' failures to comply with GAAP or other financial reporting requirements, such as SEC disclosure requirements.

<sup>34/</sup> Issuers A, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, V, Y, and Z

performed alternative procedures in connection with confirmations, and tested income tax accounts and disclosures. Engagement teams did not appropriately test these representations by, for example, reviewing appropriate source documentation, contacting outside parties, or comparing the representations to relevant industry or other public information. As one illustration, the inspection team noted instances where management's projections of future financial results appeared inconsistent with past results or trends, and yet the engagement team did not obtain sufficient competent audit evidence that supported the projections. Similarly, the inspection team noted instances where the engagement team appeared to accept management's views regarding the appropriate accounting for transactions without engaging in its own specific analysis of the GAAP requirements.

These deficiencies may result, in part, from a Firm culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence, and that rely largely on management representations. While it appears that the Firm has instituted positive changes to its audit practice over the years of PCAOB inspections, and that the Firm's senior leadership has accepted the need to do so, some questions remain about whether the Firm's audit personnel have embraced the concept that change in audit performance is necessary in order to achieve compliance with PCAOB standards. Further, the weaknesses in the Firm's consultation policies (which are described below) may have contributed to certain of the deficiencies described above. Firm personnel have expressed the view that the Firm has a robust culture of consultation. Yet the nature and number of deficiencies noted call into question the effectiveness of the Firm's consultations. Further, the Firm's limited number of required consultations, combined with the tiered nature of its consultation processes, which permits many consultations to be conducted at a lower level, may allow these types of deficiencies to persist.

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### C. Independence

The Firm's policies and procedures regarding independence with respect to foreign affiliated firms appear to be deficient. The Firm is a member firm of Deloitte Touche Tohmatsu ("DTT"). While DTT requires its member firms to inform the lead client service partner prior to performing any service for an issuer audit client of one of the member firms, the Firm has no formal system in place to monitor the services its foreign affiliates actually perform.

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E. Consultations

The engagement reviews provide cause for concern that the Firm's quality controls may not result in appropriate and effective consultations when necessary. \* \* \* \* Further, the Firm's policy on consultations, \* \* \* \* which provides a tiered hierarchy of levels of consultations, appears to be deficient in that it lacks a mechanism reasonably designed to provide that significant, complex matters are raised to the appropriate level in the hierarchy in order to ensure a sufficient level of rigor in the analysis.

The inspection team identified complex fact patterns in significant accounting and auditing areas, which were associated with deficiencies noted in seven engagements,<sup>35/</sup> including five engagements<sup>36/</sup> discussed in Part I.A, where the engagement teams did not consult with the Firm's National Accounting Research or Quality Assurance departments. In addition, \* \* \* \* engagement teams consulted in three instances at below "Level A," and neither the engagement team nor the National Accounting Research personnel raised the issue to a higher level as allowed by the policies. Consultation at "Level A" may have entailed the precision and thoroughness needed to reach the appropriate conclusions. In each of these three situations, the issuer ultimately restated its financial statements to change the accounting in the area that was the subject of the consultation.

\* \* \* \*

G. Foreign Affiliates

Deloitte Touche Tohmatsu ("DTT") uses its global internal inspection program to assess and monitor the quality of the audit work of its member firms. However, the specific results of the inspections of member firms or practice offices are not disseminated to the Firm's partners. Under DTT's practices, a U.S. engagement partner would be notified of a deficiency in a specific practice office or member firm only if there was a finding from a global internal inspection on the work performed by the foreign affiliate on that U.S. partner's issuer audit client. Accordingly, the global internal

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<sup>35/</sup> Issuers A, C, D, H, I, J, and AG

<sup>36/</sup> Issuers A, C, D, H, and I

inspection program does not routinely provide a U.S. engagement partner with a basis for assessing a foreign office's qualifications and familiarity with U.S. GAAP, PCAOB standards, and SEC reporting requirements.

\* \* \* \*

## **APPENDIX B**

### **THE INSPECTION PROCESS**

The inspection process was designed and performed to provide a basis for assessing the degree of compliance of the Firm with applicable requirements related to auditing issuers. This process included reviews of components of selected issuer audits completed by the Firm. These reviews were intended both to identify deficiencies, if any, in those components of the audits and to determine whether the results of those reviews indicated deficiencies in the design or operation of the Firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain functional areas of the Firm that could be expected to influence audit quality.

#### **1. Review of Selected Audits**

The inspection team reviewed aspects of selected audits, which it chose according to the Board's criteria. The Firm was not allowed an opportunity to limit or influence the engagement selection process or any other aspect of the review.

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenues, fair value, financial instruments, derivatives, income taxes, reserves or estimated liabilities, inventories, consideration of fraud, related party transactions, supervision of work performed by foreign affiliates, and assessment of risk by the engagement team. The inspection team also analyzed, for certain engagements, potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. For certain selected engagements, the inspection team reviewed written communications between the Firm and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

When the inspection team identified a potential issue, it discussed the issue with members of the engagement team. If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other documentation, the inspection team issued a comment form on the matter and the Firm provided a written response to the comment form.



## 2. Implementation of AS No. 2

The inspection team reviewed aspects of the Firm's approach to the implementation of AS No. 2 in light of the provisions of that standard and related Board statements.<sup>37/</sup> The inspection procedures included meeting with members of the Firm's leadership to hear the Firm's perspective on its implementation of the standard and performance of integrated audits of accelerated filers; reviewing changes to the Firm's methodology, tools, and training; and reviewing aspects of specific internal control audits. The reviews of specific audits included inspection procedures that were performed to follow up on certain matters identified in the prior year's inspection in one or more of the following areas: (1) integrating the audit of internal control with the audit of the financial statements; (2) using a top-down approach to the audit; (3) using a risk-based approach; and (4) using the work of others. The reviews of audits also included, for certain audits selected for inspection during the regular practice office field work, an evaluation of aspects of the Firm's audit of internal control.

## 3. Review of Eight Functional Areas

The inspection team reviewed the eight functional areas both to identify possible defects in the Firm's system of quality control and, where applicable, to update the Board's knowledge of the Firm's policies and procedures in the functional areas.

### a. Review of Partner Evaluation, Compensation, Admission, Assignment of Responsibilities, and Disciplinary Actions

The objective of the inspection procedures was to assess whether the design and application of the Firm's processes related to partner evaluation, compensation, admission, assignment, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm. The inspection team interviewed members of the Firm's leadership, as well as audit partners in practice offices, regarding these topics. In addition, the inspection team reviewed a sample of partners' personnel files, including files of partners who resigned or took early retirement, partners who had significant negative inspection results from recent internal, PCAOB, and peer-review inspections, and partners who received bonus compensation. Also, the inspection team interviewed audit partners regarding their time and responsibilities and interviewed

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<sup>37/</sup> See PCAOB Release No. 2005-009, *Policy Statement Regarding Implementation of [AS No. 2]* (May 16, 2005); PCAOB Release No. 2005-023, *Report on the Initial Implementation of [AS No. 2]* (Nov. 30, 2005); see also Staff Questions and Answers, *Auditing Internal Control Over Financial Reporting* (May 16, 2005).

practice office leadership regarding the evaluation and compensation process, and interviewed Firm leadership regarding any disciplinary actions.

b. Review of Independence Policies

The objective of the inspection procedures in this area was to evaluate the Firm's policies and procedures for compliance with the independence requirements applicable to its audits of issuers. To accomplish this objective, the inspection team reviewed the Firm's policies, procedures, and guidance; reviewed the Firm's monitoring of compliance with its policies and procedures; reviewed information concerning the Firm's existing business ventures, alliances, and arrangements, as well as the Firm's process for establishing such enterprises; interviewed numerous National Office and practice office personnel regarding the Firm's independence policies, practices, and procedures; and, for a sample of the audits reviewed, tested compliance with the Firm's policies and applicable independence requirements.

c. Review of Client Acceptance and Retention Policies

The objectives of the inspection procedures in this area were to evaluate whether the Firm appropriately considers and addresses the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed the Firm's policies, procedures, and forms related to client acceptance and continuance; interviewed members of the Firm's leadership; and for a sample of the engagements reviewed, assessed whether the audit procedures included the specific actions, if any, contemplated in response to any risks identified in the client acceptance or retention process.

d. Review of Practices for Consultations

The objective of the inspection procedures in this area was to assess the effectiveness of the Firm's consultation process. Toward this objective, the inspection team gained an understanding of and evaluated the Firm's policies and procedures relating to its consultation process, and reviewed a sample of consultations that occurred during the inspection period to evaluate the Firm's compliance with its policies and procedures, whether the conclusions were in accordance with professional standards, and whether the engagement teams acted in accordance with the conclusions.

e. Review of Internal Inspection Program

The objective of the inspection procedures in this area was to evaluate the effectiveness of the Firm's internal inspection program in enhancing audit quality. To

meet this objective, the inspection team reviewed policies, procedures, guidance, and forms; documentation of the results of the current year's internal inspection program; and steps the Firm took in response to those results. The inspection team also interviewed the Firm's leadership concerning the process and effectiveness of its internal inspection program. In addition, the inspection team reviewed certain audits that the Firm had inspected and compared its results to those from the internal inspection.

f. Review of Policies and Procedures for Staffing Audits

The objectives of the inspection procedures in this area were to understand and evaluate the Firm's policies and procedures for allocating, monitoring, and managing its personnel resources. Toward those objectives, the inspection team reviewed documentation relating to the Firm's processes for allocating its personnel resources and interviewed the responsible persons at the National Office and practice offices regarding such policies and procedures and their implementation.

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 that its foreign affiliates perform on the foreign operations of U.S. issuers is effective and in accordance with applicable standards. Except for one audit for which the inspection team requested access, which the Firm provided, the inspection team did not inspect the audit work of foreign affiliates; rather, the procedures were limited to the supervision and control exercised by the U.S. engagement team over such work. To accomplish its objective, the inspection team reviewed the Firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the operations of U.S. issuer clients, reviewed available information relating to the most recent foreign affiliated firms' internal inspections, interviewed members of the Firm's leadership, and reviewed the U.S. engagement teams' supervision and control procedures concerning the audit work that the Firm's foreign affiliates performed on a sample of audits.

h. Review of Tone at the Top

The objective of the review of the Firm's "tone at the top" was to assess whether actions and communications by the Firm's leadership demonstrate a commitment to audit quality. Toward that end, the inspection team interviewed members of the Firm's national, regional, and local leadership to understand their perspectives on the Firm's culture and the messages being conveyed by leadership. The inspection team also interviewed certain audit partners and managers to obtain their perspectives on communications from the Firm's leadership. In addition, the inspection team reviewed the Firm's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of,

and relationships between and among, staff and leadership; internal and external communications from management; and agendas and minutes of the Firm's board of directors.

## **APPENDIX C**

### **RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.<sup>38/</sup>

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<sup>38/</sup> In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.

April 30, 2008

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

Re: Deloitte & Touche LLP – Response to Part I of Draft Report on 2007 Inspection

Dear Mr. Diacont:

Deloitte & Touche LLP (“D&T”) is pleased to submit its response to the Public Company Accounting Oversight Board’s (the “Board”) March 31, 2008 draft of its Report on 2007 Inspection of Deloitte & Touche LLP (the “Draft Report”). We are supportive of the inspection process and believe the Board’s comments and observations enhance the ability to achieve our shared objective of improving audit quality.

D&T is committed to the highest standards of audit quality. We continually monitor the systems and processes for our audit practice, including quality control, and, among other things, make changes to methodologies, policies, and procedures when we identify improvements that could enhance audit quality. As we have done with respect to the Board’s previous inspection reports, we will thoroughly consider the Board’s comments and concerns addressed in the Draft Report, assess whether we have already initiated actions that address those concerns, and consider whether additional actions are necessary.

We believe that the observations included in the Draft Report reflect the fact that professional judgments are involved both in auditing an Issuer’s financial statements as well as in subsequently inspecting any such audits. Professional judgments of reasonable and highly competent people may differ as to the nature and extent of necessary auditing procedures, conclusions reached and required documentation. We believe that reasonable judgments should not be second guessed and therefore disagree with a number of comments as indicated below.

We view the PCAOB’s observations as constructive, and, accordingly, give each comment careful and thoughtful consideration. Although we may not always agree with the characterization by the PCAOB in the Draft Report of our audit work and related documentation, we have evaluated the matters identified by the Board’s inspection team for each of the nine Issuer audits described in Part I of the Draft Report.

With respect to the two departures from generally accepted accounting principles cited in Part I of the Draft Report, the Issuer clients and we considered AU 561, *Subsequent*

Mr. George Diacont  
April 30, 2008  
Page 2

*Discovery of Facts Existing at the Date of the Auditor's Report*, and, as noted in the Draft Report, these Issuers restated their financial statements to correct an accounting error.

With respect to the remaining Issuer audits cited in Part I of the Draft Report, in some instances we have supplemented our documentation to add clarity or we have performed certain additional procedures in response to the inspection findings. In this regard, we have fulfilled our professional responsibilities under AU 390, *Consideration of Omitted Procedures After the Report Date*, and in those instances where we performed and/or documented additional auditing procedures, none of our conclusions or our reports on the Issuers' financial statements were affected.

With respect to the observations in the second bullet related to Issuer A and the first, second, fourth and fifth bullets related to Issuer E, we believe that the audit procedures performed, the conclusions reached and the related documentation were appropriate in the circumstances, and, accordingly, we believe such observations should not be included in the final report.

\* \* \* \* \*

We appreciate the opportunity to provide our response to the Draft Report and look forward to continuing to work with the PCAOB in support of efforts to improve audit quality. We are available to the Board and its staff to discuss our response in further detail.

Sincerely,

Deloitte + Touche LLP



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April 30, 2008

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

Re: Deloitte & Touche LLP – Non-public response to Part II of Draft Report on  
2007 Inspection

Dear Mr. Diacont:

In accordance with your transmittal letter, dated March 31, 2008, and the provisions of the Sarbanes-Oxley Act of 2002, Deloitte & Touche LLP (“D&T” or the “Firm”) understands that the following comments relating to Part II of the Public Company Accounting Oversight Board’s (the “Board”) March 31, 2008 draft of its Report on 2007 Inspection of Deloitte & Touche LLP (the “Draft Report”) will not be included in the final inspection report that will be made publicly available. Further, nothing in this preliminary response should be deemed to waive or limit in any way D&T’s ability, consistent with the regulatory regime, to assert its confidentiality rights and interests or to submit additional comments hereafter. We are supportive of the inspection process and believe the Board’s comments and observations enhance the ability to achieve our shared objective of improving audit quality.

As we have done with respect to the Board’s previous inspection reports, we will thoroughly consider the Board’s comments and concerns addressed in the Draft Report, assess whether we have already initiated actions that address those concerns, and consider whether additional actions are necessary.

We believe that the observations included in the Draft Report reflect the fact that professional judgments are involved both in auditing an Issuer’s financial statements as well as in subsequently inspecting any such audits. Professional judgments of reasonable and highly competent people may differ as to the nature and extent of necessary auditing procedures, conclusions reached and required documentation. We believe that reasonable judgments should not be second guessed and, therefore, disagree with a number of comments as indicated below. We view the PCAOB’s observations as constructive, and, accordingly, give each comment careful and

PRIVILEGED AND CONFIDENTIAL AND ALSO PROTECTED BY SECTIONS 104(g)(2)  
AND 105(b)(5) OF THE SARBANES-OXLEY ACT AND REGULATIONS THEREUNDER

Member of  
Deloitte Touche Tomatsu



thoughtful consideration. Although we may not always agree with the characterization by the PCAOB in the Draft Report of our audit work and related documentation, we have evaluated the matters identified by the Board's inspection team described in Part II of the Draft Report.

At this time, we have the following specific comments on Part II of the Draft Report:

- In most sections of Part II of the Draft Report, the Board expresses "...cause for concern about the effectiveness of the Firm's quality controls...". However, in some cases the concerns noted by the Board are based only on limited instances observed by the inspection team, yet the implication is that such concerns indicate a broad issue in our audit practice as a whole. We believe that observations should not be included in Part II when there are only a limited number of instances on which they are based, certain of which instances we disagreed with in our written responses to the inspection team's comments.
- Section A.2 includes the Board's general observations about audit performance and reflects the Board's view that the "these deficiencies may result, in part, from a Firm culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence, and that rely largely on management representations." We believe that such a broad statement by the Board mischaracterizes our audit approach and our practices. Further, we strongly take exception to the observation that our culture or system of quality control allows or tolerates such audit approaches. The magnitude of the number of judgments made during the course of each Issuer audit must be considered, notwithstanding the individual findings of the inspection team on some of the Issuer audits inspected (some of which findings we disagreed with in our written responses to the inspection team's comments). We do not believe that the inspection results support such a broad statement by the Board and such statement should not be included in the final report.

REDACTED

Comments on Non-public Aspects of Report

REDACTED

Comments on Non-public Aspects of Report

- Section E includes the Board's observations related to consultations and indicates the Board's concerns that the Firm's quality controls may not result in appropriate and effective consultations. Specifically, the Board stated that the Firm's policy on consultations appears to be deficient in that "it lacks a mechanism reasonably designed to provide that significant, complex matters are raised to the appropriate level in the hierarchy in order to ensure a sufficient level of rigor in the analysis." We do not agree that our policy on consultations is deficient in this regard. We believe it is appropriate to rely on the judgment of the audit engagement partner, concurring review partner and any other consulted parties to decide on the appropriate level in the hierarchy for a consultation. Our guidance includes a section specifically indicating that, based on the information exchanged during the consultation process, either the audit engagement partner or the consulted party may determine that the objective, nature, or scope of the consultation needs to be expanded or that others need to be included in the consultation process. Therefore, we disagree with the inclusion of this comment in the final report.

REDACTED

Comments on Non-public Aspects of Report

REDACTED

Comments on Non-public Aspects of Report

- Section G includes the Board's observations related to Deloitte Touche Tohmatsu's (DTT) global inspection program to assess and monitor the quality of the audit work of its member firms and indicates that specific results of the inspections of member firms or practice offices are not broadly disseminated to the Firm's partners. The Board then concludes that the global internal inspection program does not routinely provide an individual partner a basis for assessing a foreign firm's qualifications and credentials. We believe that there are processes in place that provide the Firm's audit partners with an appropriate basis to assess the qualifications and credentials of the engagement team members from DTT member firms who perform audit work on non-U.S. units in connection with the Firm's audits of Issuers. Accordingly, we do not believe the Board's observation identifies or relates to a weakness in the Firm's quality control system or its application, thus the comments in Section G should not be included in the final report.

\* \* \* \* \*

We are available to the Board and its staff to discuss our response in further detail.

REDACTED

Sincerely,

*Deloitte + Touche LLP*