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## **Report on**

# **2009 Inspection of Deloitte & Touche LLP (Headquartered in New York, New York)**

**Issued by the**

**Public Company Accounting Oversight Board**

**May 4, 2010**

**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. 104-2010-050



### **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.

### 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.

## **2009 INSPECTION OF DELOITTE & TOUCHE LLP**

In 2009, the Board conducted an inspection of the registered public accounting firm Deloitte & Touche LLP ("Deloitte" or "the Firm"). The Board is 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") conducted primary procedures for the inspection from October 2008 through October 2009. The inspection team performed field work at the Firm's National Office and at 30 of its approximately 69 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 and the review of certain firm-wide quality control processes.

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.

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

The inspection procedures included reviews of aspects of 73 audits performed by the Firm. The scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope.

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<sup>3/</sup> This focus on weaknesses and deficiencies 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 it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

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 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

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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.

<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. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* ("AS No. 5"), ¶ 98.

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 or internal control over financial reporting ("ICFR"). The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis.

#### Issuer A

The issuer's total U.S. net federal deferred tax assets, which exceeded its stockholders' equity at year end, included substantial U.S. income tax net operating loss carry forwards for which no valuation allowance had been recorded. The issuer used a number of subjective assumptions about future events to support its position that it was more likely than not that the net deferred tax assets would be realized. For example, the issuer forecasted taxable income over the twenty years (which is four times as long as the issuer's strategic planning horizon) needed to fully use the net deferred tax asset; the issuer's forecasted taxable income over the twenty-year period was based on an average of the most recent three years' income, excluding non-recurring items and adjusted for expected changes to profit; and the issuer relied on tax planning strategies involving significant future repatriation of dividends to the U.S. to generate future U.S. taxable income. The Firm concurred that it was more likely than not that the issuer's net deferred tax assets would be realized. The Firm, however, failed to give sufficient weight to relevant evidence that was more objectively verifiable, such as the fact that the issuer had experienced losses in seven of the last eight years (including cumulative losses in the last three years), had experienced two successive year-over-year declines in U.S. sales volumes, and considered the disruptions in the financial markets to be a risk factor to its business. Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes* requires that the weight given to the potential effect of evidence be commensurate with the extent to which the evidence can be objectively verified.

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<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.



## Issuer B

The issuer evaluated its recorded goodwill for impairment during the third quarter of the year and concluded that the fair value of its total assets exceeded their book value by a small margin. Several significant developments occurred between the date of the third quarter evaluation and the issuer's year end, such as a reduction in the issuer's revenue estimate for 2009, a significant decrease in the market value of the issuer's stock (exceeding that of market indices generally), and liquidity issues facing the issuer, that may have indicated that goodwill had been impaired. The Firm failed to sufficiently evaluate the effect of these events on its assessment of the potential impairment of goodwill at year end. Specifically:

- The Firm failed to consult at year end with the valuation specialists used in the initial third quarter impairment assessment regarding these changes in circumstances.
- The Firm failed to sufficiently assess the consequences of the lower 2009 revenue estimate on the issuer's projected significant increases in revenue and profits in future years as the Firm continued to rely on information that was developed prior to the issuer's revisions to its 2009 outlook.
- The Firm failed to sufficiently evaluate the reasonableness of the projected improvements in gross margin, because it relied on unsupported expected future changes in product mix and expected cost containment initiatives that were only partially verifiable. At the same time, the issuer's projected major source of growth involved large-scale projects into which the issuer's products would be incorporated, but the Firm failed to assess the effects of the current economic environment on the ability of the issuer's customers to obtain financing for the continually increasing number of such projects that would be necessary for the issuer to achieve its projections.
- The Firm also failed to sufficiently assess the effects of the significantly lower market value of the issuer's stock because it failed to assess the likelihood of the issuer achieving the year-end implied control premium (between 70 and 75 percent) that was almost three to five times the control premiums that valuation specialists had indicated were reasonable at the time of (or shortly before) the initial impairment assessment was made.
- The Firm failed to evaluate the effects that the recent liquidity issues might have on the cost of equity capital and thus on the weighted-average cost of capital, which was a significant input into the projected discounted cash flows.
- The Firm failed to sufficiently evaluate the reasonableness of the issuer's use of the stated rate on certain debt in the computation of the weighted-average cost of capital because the Firm failed to consider (a) the issuer's disclosures of liquidity issues that it began experiencing during the third quarter of the year and (b) the



fact that the issuer had extinguished a portion of that debt at approximately a 45 percent discount from par during the fourth quarter.

#### Issuer C

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 adequate audit procedures to test the valuation of the issuer's inventory and investments in joint ventures (the primary assets of which were inventory). Specifically, the Firm:
  - Failed to re-evaluate, in light of a significant downturn in the issuer's industry and the general deterioration in economic conditions, whether the issuer's assumption, which it had also used in prior years, that certain inventory required no review for impairment was still applicable in the year under audit;
  - Excluded from its impairment testing a significant portion of the inventory that may have been impaired, because the Firm selected inventory items for testing from those for which the issuer already had recorded impairment charges;
  - Failed to evaluate the reasonableness of certain of the significant assumptions that the issuer used in determining the fair value estimates of inventory and investments in joint ventures;
  - Failed to obtain support for certain of the significant assumptions that the Firm used when developing an independent estimate of the fair value of one category of inventory; and
  - Failed to test items in a significant category of inventory, which consisted of all items with book values per item below a Firm-specified amount that was over 70 percent of the Firm's planning materiality.
- The Firm failed to perform adequate audit procedures to evaluate the issuer's assertion that losses related to the issuer's guarantees of certain joint venture obligations were not probable, because the Firm's procedures were limited to inquiry of management.

#### Issuer D

In this audit, the Firm failed to adequately test the valuation of the issuer's inventory and the issuer's investments in unconsolidated entities, whose primary assets were inventory ("investments"). The issuer recognized impairment charges during the year that totaled approximately 24 times the Firm's materiality level. The Firm identified potential impairment as a specific identified risk. Nonetheless, a significant portion of

the inventory was excluded from testing for impairment. In addition, the Firm failed to evaluate the reasonableness of certain significant assumptions that the issuer used when estimating future cash flows in order to determine the recoverability of the inventory and investments. Further, the Firm failed to sufficiently test a significant process that the issuer used as its mechanism to identify impaired inventory and investments because the Firm failed to test certain significant information used and produced by this process.

#### Issuer E

In this audit, the Firm failed to adequately test an intangible asset for impairment. The intangible asset had been acquired as part of a business combination in a prior year and, under the purchase price allocation, the asset's value had been calculated using only the recurring maintenance revenues from the existing acquired customer base. In evaluating the issuer's assertion that no impairment was required for the recorded intangible asset, the Firm incorrectly concluded that an unrecorded intangible asset, which would be measured by future cash flows from other types of sales to the acquired customer base, could be considered in determining whether the recorded intangible asset was impaired.

#### Issuer F

In this audit, the Firm failed to perform adequate audit procedures pertaining to a sale of a subsidiary to a newly formed entity in which the issuer held an ownership interest. Specifically, the Firm failed to test the issuer's percentage of ownership sold, the appropriateness of certain adjustments to the cost basis of the subsidiary, and the reasonableness of certain significant assumptions used by the issuer in determining the fair value of the subsidiary.

#### Issuer G

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

- The issuer recorded a goodwill impairment charge based on the calculated fair values of its reporting units. For one reporting unit, the Firm failed to evaluate whether management's use of historical results as the sole basis for its revenue projections, without considering the issuer's future prospects or the economic conditions, was reasonable. Also, the Firm failed to sufficiently evaluate certain other significant assumptions used in the fair value calculation, in that its testing of these assumptions was limited to inquiry.

- The Firm failed to perform sufficient procedures to evaluate the adequacy of the issuer's inventory reserve. Specifically, the Firm failed to test a significant portion of the reserve, and it failed to test certain significant assumptions that the issuer had used to calculate certain other significant portions of the reserve.
- The Firm used positive confirmations to test the existence of inventory held by consignees. The Firm, however, failed to evaluate the authenticity of the confirmations returned through facsimile or email and also failed to perform alternative procedures on certain other confirmations that were not returned.

#### Issuer H

The issuer engaged a specialist to calculate the estimated amount of a significant contingent liability. The amount calculated by the specialist exceeded the amount recorded by the issuer by an amount that was approximately 13 times the Firm's planning materiality. The Firm failed to perform sufficient procedures to test the contingent liability, as follows:

- The Firm failed to assess the reasons for the differences between the issuer's and the specialist's assumptions.
- The Firm's testing did not address the completeness of new claims filed, which is a key input used by the issuer in estimating the amount of this contingent liability, as it neither tested the completeness of the new claims data nor obtained evidence about the operating effectiveness of controls over the completeness of those data.

In addition, the Firm failed to sufficiently test the issuer's inventory. The issuer had numerous locations with disparate systems and controls. The Firm selected certain locations for testing. For a number of other locations, whose inventory collectively represented a significant portion of the issuer's total inventory, the Firm performed a high-level analytical review and relied on certain entity-level controls, but neither the analytical review nor the controls were precise enough to identify misstatements that might be material to the financial statements.

#### Issuer I

In this audit, the Firm failed to perform adequate audit procedures to test the issuer's conclusion that certain available-for-sale securities with unrealized losses did not require a charge for other-than-temporary-impairment. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated certain of the issuer's significant assumptions and the issuer's assessments of collectibility for the securities that did not meet the Firm's criteria for detailed testing and

that represented approximately 75 percent of the issuer's gross unrealized losses on investments.

Further, the Firm failed to obtain sufficient competent evidential matter to support its opinion on the issuer's ICFR. During the fourth quarter, the issuer changed the design of an important control it used to identify securities in an unrealized loss position that needed to be evaluated for impairment. Specifically, the issuer made the criteria for requiring a credit write-up and subsequent evaluation of the documentation for those securities less strict. The Firm failed to assess the impact of this change on the design and operating effectiveness of the control.

#### Issuer J

In this audit, the Firm failed to evaluate the reasonableness of certain significant assumptions that the issuer had used in developing its cash flow estimates to assess the recoverability of certain long-lived assets, failed to consider certain information that contradicted other such assumptions, and failed to evaluate the appropriateness of the issuer's exclusion of certain other long-lived assets from its impairment analysis.

#### Issuer K

The issuer identified impairment indicators for certain long-lived assets and determined that no impairment charge should be recorded. The Firm failed to perform procedures, beyond inquiry, to evaluate the reasonableness of the issuer's determination that the assets were not impaired. Further, the Firm failed to sufficiently evaluate the reasonableness of certain significant assumptions that the issuer used in developing its cash flow estimates to assess the recoverability of certain long-lived assets. Specifically, the Firm failed to assess the appropriateness of using prior sales and costs without considering potential adjustments to this information given the current economic environment.

#### Issuer L

The issuer acquired a company during the year, and this acquired company operated as a subsidiary of the issuer after the acquisition and was the source of a significant portion of the issuer's reported revenue. The acquired company used information technology to log services provided to users, initiate bills for the services, process the billing transactions, and record such amounts in electronic accounting records that are used to produce the financial statements. The Firm failed to test the operating effectiveness of the controls over the acquired company's revenue and, as a result, the Firm's testing of revenue was inadequate. In addition, in auditing revenue, the Firm used system-generated data, but it neither tested the operating effectiveness

of controls over the generation of the data nor otherwise tested the completeness and accuracy of the data.

In addition, the Firm failed to perform adequate audit procedures to evaluate the reasonableness of the assumptions that management had used to develop discounted cash flow analyses as part of the issuer's goodwill impairment assessment. Specifically, the Firm failed to evaluate the issuer's revenue projections, other significant assumptions, and data underlying the discounted cash flow analyses by, for example, comparing the projections to historical trends and data related to customer growth and retention and by assessing the feasibility of forecasted changes in cost levels.

#### Issuer M

In this audit, the Firm failed to perform adequate audit procedures to test the fair value of an embedded derivative liability at year end. The Firm used a maximum controls-reliance approach, but it failed to test any controls that specifically related to the embedded derivative. In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of certain significant assumptions that the issuer used in its valuation model. Further, the Firm's substantive procedures were limited to a test of two data points underlying the issuer's valuation model and a reasonableness test involving calculating a range of expected ratios of the liability to the values of the host contracts. The reasonableness test, however, was not sufficiently precise to detect a material misstatement of the liability because the calculated range would have allowed variation in the liability by an amount that was approximately six times the Firm's materiality amount.

#### Issuer N

In this audit, the Firm failed to sufficiently test revenue and cost of goods sold. The Firm chose not to rely on controls over a significant number of the issuer's locations, but it relied upon certain reports generated by the systems for these locations without testing the completeness and accuracy of those reports.

#### Issuer O

In this audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. In the consolidated statement of cash flows, the issuer incorrectly classified a portion of a gain on extinguishment of

debt, thereby significantly overstating cash provided by operating activities and cash used by financing activities.<sup>9/</sup>

**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 five areas (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining clients, including the application of the Firm's risk-rating system; (4) processes related to the Firm's use of audit work that the Firm's foreign affiliates perform on the foreign operations of the Firm's U.S. issuer audit clients; and (5) the Firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to weaknesses in quality control. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of 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

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<sup>9/</sup> In subsequent filings, the issuer adjusted the statement of cash flows related to the issue referenced here.



PART II, PART III, AND APPENDIX A OF THIS REPORT ARE NONPUBLIC  
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

## **APPENDIX B**

### **THE INSPECTION PROCESS**

The inspection process was designed and performed to provide a basis for assessing the degree of compliance by 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 quality control processes of the Firm that could be expected to affect audit quality.

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

The inspection team reviewed aspects of selected audits of financial statements and ICFR, 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, revenue, fair value measurements, financial instruments, income taxes, reserves or estimated liabilities, inventories, consideration of fraud, supervision of work performed by foreign affiliates, and assessment of risk by the engagement team. The inspection team also analyzed potential adjustments to the issuer's financial statements that were identified during the audit but not corrected. 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. Review of Firm Management and Monitoring Processes Related to Audit Quality Control

The inspection team's approach to its review of the Firm's system of quality control was intended to further its understanding of how the Firm manages audit quality, so as to enhance its basis for assessing, in this year and in future years, whether that system is appropriately designed and implemented to achieve the goal of conducting audits that are in compliance with applicable standards. The inspection team also continued its assessment of the Firm's processes and controls that relate to certain specific functional areas that relate to audit performance. The overall approach was designed to identify possible defects in the design or operation of the Firm's system of quality control, while also continuing and enhancing the evaluation of the Firm's ability to respond effectively to indications of possible defects in its system of quality control.

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

The objectives of the inspection procedures in this area were (a) to update the inspection team's understanding of how the Firm's management is structured and operates the Firm's business, and the implications that the management structure and processes have on audit performance and (b) to continue assessing whether actions and communications by the Firm's leadership – the Firm's "tone at the top" – demonstrate a commitment to audit quality. Toward those ends, the inspection team interviewed members of the Firm's national leadership to obtain an understanding of any significant changes in the Firm's approach to, and processes for, its management, including the various management committees or other mechanisms, formal or informal, that relate to assessing and monitoring audit performance, or that otherwise affect audit performance.

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

The objectives of the inspection procedures in this area were (a) to continue to assess whether the design and application of the Firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm; (b) to assess the Firm's quality controls over the allocation of its partner resources; and (c) to identify and assess the accountability and responsibilities of the different levels of Firm management with respect to partner management. The inspection team interviewed members of the

Firm's management and reviewed and also evaluated documentation regarding certain of these topics.

In addition, the inspection team reviewed a sample of partners' personnel files, including files of partners who resigned and partners who had significant negative inspection results from recent internal and PCAOB inspections.

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

The objectives of the inspection procedures in this area were to continue to assess whether the Firm appropriately considers and addresses the risks involved in accepting and retaining clients in the particular circumstances and to assess the Firm's responses to the risks identified, including the extent to which an observable link exists between the identified risks of material misstatement and the audit procedures performed. Toward those objectives, the inspection team obtained an understanding of any changes in the acceptance and retention processes, evaluated the Firm's policies and procedures relating to the Firm's risk-rating systems, and interviewed members of the Firm's management.

- d. Review of Processes Related to the Firm's Use of Audit Work that the Firm's Foreign Affiliates Perform on the Foreign Operations of the Firm's U.S. Issuer Audit Clients

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. 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, 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.

- e. Review of the Firm's Processes for Monitoring Audit Performance, Including Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance, Independence Policies and Procedures, and Processes for Responding to Weaknesses in Quality Control
  - (i) Review of Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance

The objective of the inspection procedures in this area was to continue to identify and assess the monitoring processes that the Firm considers to be significant to its ability to monitor audit quality for individual engagements and for the Firm as a whole. Toward that objective, the inspection team interviewed members of the Firm's management and reviewed certain documents to build on its understanding of how the Firm identifies, evaluates, and responds to possible indicators of deficiencies in audit performance, including internal inspection findings, PCAOB inspection observations, restatements, and litigation. In addition, the inspection team reviewed documents related to the design, operation, and evaluation of findings of the Firm's internal inspection program. The inspection team also reviewed certain audits that the Firm had inspected and compared the results to those of the Firm.

- (ii) Review of Response to Weaknesses in Quality Control

The objectives of the inspection procedures in this area were to assess the design and test the effectiveness of the Firm's processes for addressing possible deficiencies in the Firm's system of quality control, including any deficiencies in the Firm's system of quality control that were noted in prior PCAOB inspection reports. Toward those objectives, the inspection team reviewed steps the Firm has taken in the past several years to address possible quality control deficiencies. The inspection team interviewed members of the Firm's national and regional leadership and conducted focused inspections of audits to assess the design and effectiveness of the processes identified. In addition, the inspection team conducted focused inspections of audits of certain issuers whose audits had been reviewed during previous PCAOB inspections of the Firm to ascertain whether the audit procedures in areas with previous deficiencies had been improved.

- (iii) Review of Certain Other Policies and Procedures Related to Monitoring Audit Quality

In this area, the procedures included obtaining an update of the inspection team's understanding of policies, procedures, and guidance related to aspects of the Firm's independence requirements and its consultation processes and the Firm's compliance

with them. In addition, the inspection team reviewed documents, including certain newly issued audit policies and procedures, and interviewed Firm management to update its understanding of the Firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.



## **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>10/</sup>

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<sup>10/</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.



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April 9, 2010

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 2009 Inspection

Dear Mr. Diacont:

Deloitte & Touche LLP (D&T) is pleased to submit its response to the March 10, 2010 draft of the Public Company Accounting Oversight Board (the PCAOB or the Board) Report on 2009 Inspection of Deloitte & Touche LLP (the Draft Report). We are committed to the highest standards of audit quality and believe that the PCAOB's inspection process is an important factor in the achievement of our shared objectives of improving audit quality and serving investors and the public interest. We continually monitor the systems and processes of 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.

We have evaluated the matters identified by the Board's inspection team for each of the Issuer audits described in Part I of the Draft Report and have taken actions as appropriate in accordance with D&T's policies and PCAOB standards. In this regard, we have fulfilled our professional responsibilities under AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*; none of our reports on the Issuers' financial statements was affected.

\* \* \* \* \*

We are supportive of, and committed to, working with the PCAOB to continue to strengthen trust in the integrity of the independent audit. We are available to the Board and its staff to discuss our response in further detail.

Sincerely,