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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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In the Matter of)		PCAOB Release No.104-2014-101
Ernst & Young LLP's)		
Quality Control Remediation)		
Submission)		
)		June 11, 2014
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I.

The Public Company Accounting Oversight Board ("Board" or "PCAOB") has evaluated the submission of Ernst & Young LLP ("the Firm") pursuant to PCAOB Rule 4009(a) for the remediation period ended November 30, 2012, concerning the Firm's efforts to address certain quality control criticisms included in the nonpublic portions of the Board's November 30, 2011 inspection report on the Firm ("the Report"). The Board has determined that as of November 30, 2012, the Firm had not addressed certain criticisms in the Report to the Board's satisfaction. Accordingly, pursuant to Section 104(g)(2) of the Sarbanes-Oxley Act of 2002 ("the Act") and PCAOB Rule 4009(d), the Board is making public the portions of the Report that deal with those criticisms.¹

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

¹ Those portions of the Report are now included in the version of the Report that is publicly available on the Board's web site. Observations in Board inspection reports are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability.

II.

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

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

ISSUED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

June 11, 2014



Statement of Ernst & Young LLP on the PCAOB's June 11, 2014 Release No. 104-2014-101

At EY, we are committed to serving our stakeholders – shareholders, audit committees, companies, regulators and the markets generally – who count on us to deliver high quality audits. The performance of quality audits is our number one priority. It is for this reason that, since it was created by the Sarbanes-Oxley Act of 2002, we have supported the mission of the Public Company Accounting Oversight Board. The PCAOB inspection process unquestionably has led to improvements in the quality of audits by our firm and the profession more broadly.

The Board is making public portions of Part II of our 2010 Inspection Report relating to two areas where the Board found that our remediation efforts were insufficient. We have taken substantial remedial actions with respect to both matters, including significantly enhancing our policies and practices in the two areas noted. This includes providing our audit professionals with new audit tools, additional training and expanded technical guidance. More broadly, we have also significantly increased the number of partners and staff devoted to quality-control and quality-improvement measures across our firm. These efforts have been beneficial generally and continue to improve the quality of the audits we perform.

At the same time, we can and will continue to improve the quality of our audits – both generally and in the areas highlighted by the publicly released portions of Part II of our 2010 Inspection Report. Our commitment to high quality audits extends to all levels of the firm, from our leadership to our audit teams.

We accept and take very seriously the Board's determination regarding the firm's two areas of remediation in Part II. We share with the Board a common objective to see continuous improvement in the quality of our work and we are firmly committed to this objective and to working with the Board in a cooperative and constructive manner. We also note the Board has stated that "[i]t is not unusual for an inspection report to include nonpublic criticisms of several aspects of a firm's system of quality control" and that a public release of those criticisms "is not a broad judgment about the effectiveness of a firm's system of quality control compared to those of other firms, and it does not signify anything about the merits of any additional efforts a firm may have made to address the criticisms after the 12-month period."

We fully appreciate our important duty to the public trust and capital markets. We look forward to working with the Board on our ongoing efforts to improve audit quality.

Report on
2010 Inspection of Ernst & Young LLP
(Headquartered in New York, New York)

Issued by the
Public Company Accounting Oversight Board

November 30, 2011

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



Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the 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.

2010 INSPECTION OF ERNST & YOUNG LLP

Preface

In 2010, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young LLP ("E&Y" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is issuing this report in accordance with the requirements of the Act.^{1/} The Board is releasing to the public Part I of the report, Appendix C, and portions of Appendix D. Appendix C provides an overview of the inspection process for annually inspected firms.^{2/} Appendix D includes the Firm's comments, if any, on a draft of the report.^{3/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), is nonpublic, unless the firm fails to make sufficient progress in addressing those criticisms.

^{1/} In its Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004), the Board described its approach to making inspection-related information publicly available consistent with legal restrictions.

^{2/} The Act requires the Board to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers.

^{3/} 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.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm performs audit work.^{4/} To achieve that goal, Board inspections include reviews of certain aspects of selected audit work performed by the firm and reviews of certain aspects of the firm's quality control system. It is not the purpose of an inspection, however, to review all of a firm's audit work or to identify every respect in which reviewed work is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audit work, or the relevant issuers' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

If the Board inspection team identifies deficiencies that exceed a certain significance threshold in the audit work it reviews, those deficiencies are summarized in the public portion of the Board's inspection report.^{5/} The Board cautions, however, against extrapolating from the results presented in the public portion of the report to broader conclusions about the frequency of deficiencies throughout the Firm's practice. Audit work is selected for inspection largely on the basis of an analysis of factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

^{4/} 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.

^{5/} Inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. 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. 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. The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements. Failure by a firm to take appropriate actions, or a firm's misrepresentations, in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures for the inspection from March 2010 to December 2010. The inspection team performed field work at the Firm's National Office and at 30 of its approximately 63 U.S. practice offices.

A. Review of Audit Engagements

The 2010 inspection of the Firm included reviews of aspects of 62 audits performed by the Firm and a review of the Firm's audit work on another issuer audit engagement in which the Firm played a role but was not the principal auditor. The inspection team selected the audits and aspects to review, and the Firm was not allowed an opportunity to limit or influence the selections.

The inspection team identified matters that it considered to be deficiencies in the performance of the audit work it reviewed. Those deficiencies included the failure by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,^{6/} as well as 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 was based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claimed to have performed the procedure.^{7/}

^{6/} 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 applicable accounting principles, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

^{7/} PCAOB Auditing Standard No. 3, *Audit Documentation* provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence.

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, 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 failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR"). The audit deficiencies that reached these levels of significance are described below.^{8/}

1. Deficiencies in Testing the Fair Value Measurements and Disclosures of Financial Instruments Without Readily Determinable Fair Values

In seven audits,^{9/} due to deficiencies in testing the fair value measurements of, and the disclosures related to, financial instruments without readily determinable fair values ("hard-to-value financial instruments"), including private debt securities, U.S. government agency securities, auction-rate securities, interest rate swaps and options, asset-backed securities, and collateralized debt obligations, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions. The deficiencies are as follows –

- In six of the seven audits,^{10/} the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying certain fair value measurements obtained from pricing services or other third parties and used in the Firm's testing of the fair value of the hard-to-value financial instruments. Further, in three of these audits,^{11/} the Firm's primary substantive procedure to test the fair values of certain financial instruments was to obtain prices from outside pricing services but, for some of the financial instruments that it tested in this way, the fair value

^{8/} 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.

^{9/} Issuers A, B, C, D, E, F, and G

^{10/} Issuers A, B, C, D, E, and F

^{11/} Issuers A, B, and E

measurements the Firm obtained were from the same pricing service that the issuer had used.

- In addition, in five of the seven audits,^{12/} the Firm failed to evaluate the implications of significant differences in fair value measurements from different sources for individual financial instruments.
- There were additional deficiencies related to the Firm's testing of the fair value of financial instruments in four of these audits:
 - In three of these audits,^{13/} the Firm performed substantive testing at an interim date, but failed to perform sufficient procedures to provide a reasonable basis for extending its conclusions to year end regarding the valuation of hard-to-value financial instruments for which the Firm had identified a fraud risk and/or other significant risk. In one of these three audits,^{14/} the Firm's roll-forward procedures for certain categories of securities were limited to comparing the recorded values at the date of its substantive testing, three months before year end, to those at year end. In another of these three audits,^{15/} the roll-forward procedures for certain categories of securities to cover the three-month period from interim testing to year end included a review of testing performed by the issuer's internal auditors ("IA"), which consisted of verifying that certain control activities had occurred, and performing analytical procedures that were not at a level of precision to detect a material misstatement. In addition, the Firm did not obtain corroboration of management's explanations for significant differences identified. In the third audit,^{16/} the Firm failed to

^{12/} Issuers A, B, C, E, and G

^{13/} Issuers A, D, and F

^{14/} Issuer A

^{15/} Issuer D

^{16/} Issuer F

perform year-end procedures to test fair values of securities, which the issuer had based upon broker quotes obtained 30 days prior to year-end.

- In one audit,^{17/} the Firm failed to appropriately test the fair value of certain auction-rate securities ("ARS"). The Firm applied a discount to the ARS that it derived from testing a separate population of ARS using a discounted cash flow methodology, but failed to determine whether the characteristics of the untested ARS were similar to those valued using the discounted cash flow method. In addition, to evaluate the fair value of certain other financial instruments, the Firm used prices from certain recent sales. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the investments being valued were comparable to the investments included in this population.
- In one audit,^{18/} the Firm failed to evaluate the issuer's process for the resolution of pricing exceptions identified during the operation of controls, including exceptions related to securities with missing or stale prices.
- One issuer^{19/} used an external specialist to determine the fair value of certain financial instruments. The Firm failed to adequately test the issuer's fair value measurements. Specifically,
 - The Firm compared the specialist's projected loss and discount rate assumptions to independently developed ranges for these assumptions, but these ranges were not narrow enough to identify a potentially material misstatement. The Firm also compared the discount rates that the issuer used to the results of a pricing analysis prepared by the issuer's external specialist, but failed to test the underlying information used in that analysis.

^{17/} Issuer G

^{18/} Issuer A

^{19/} Issuer G

- The Firm failed to evaluate whether the securities that the issuer's external specialist used to substantiate the issuer's yields were comparable to the issuer's securities.
- In one audit,^{20/} the Firm failed to evaluate the appropriateness of the issuer's valuation model used to price certain hard-to-value financial instruments.
- In one audit,^{21/} the Firm inappropriately used the work of IA in testing important controls and performing substantive tests over the valuation of hard-to-value securities, a complex and subjective area. For example, the Firm used the work of internal audit in testing the issuer's manual adjustments to prices received from external pricing service prices and to valuations derived from models.
- In two of these seven audits,^{22/} the Firm failed to adequately test the issuer's disclosures of certain hard-to-value financial instruments as level 2 or level 3 because it failed to obtain an understanding of whether significant inputs used to value the financial instruments were observable or unobservable.

2. Issuer H

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR, as follows –

- Regarding the Firm's opinion on the effectiveness of ICFR –
 - The issuer has multiple production sites. In scoping the audit, the Firm assumed that risks and controls were the same across all locations and therefore reduced the number of sites at which it performed testing.

^{20/} Issuer F

^{21/} Issuer D

^{22/} Issuers A and D

These assumptions, however, were incorrect, as the issuer had grown through significant acquisition activity in the prior years, and a number of the acquired locations operated using differing systems and controls. In addition, the Firm, along with the issuer's IA, identified multiple control failures, including failures at most locations, but the failures were not consistent across all locations.

- The Firm failed to evaluate whether the numerous and wide-ranging control deficiencies that it and IA had identified were, in combination, material weaknesses, and to evaluate the effect that these control deficiencies should have had on the nature, timing, and extent of its substantive audit procedures.
- The Firm determined that the information technology general controls ("ITGCs") over two systems were ineffective but nonetheless relied on financial information generated from those systems in its testing of controls without testing the completeness and accuracy of that information.
- The Firm failed to adequately test system-related controls over revenue and accounts receivable and inventory, as it failed to test the effectiveness, as a control, of the issuer's segregation of duties and failed to test controls intended to mitigate the risk of management override.
- The Firm failed to sufficiently test the completeness and valuation of inventory, as the nature, timing, and extent of its substantive procedures did not take into account exceptions it identified in its testing of inventory costs and inventory cut-off.
- Other than by obtaining issuer-prepared memoranda, the Firm failed to evaluate the issuer's accounting for certain debt issuances and payment remittances as an extinguishment of existing debt and issuance of new debt. In addition, the Firm failed to evaluate whether the issuer appropriately accounted for an amendment to a debt agreement. Further, the Firm relied on management's uncorroborated representations to determine whether the issuer was in compliance with certain debt covenants.

- In the fourth quarter, the issuer recorded a significant impairment charge related to its property, plant, and equipment. The Firm failed to evaluate whether the timing of this charge was appropriate. The Firm also failed to test controls over the identification of triggering events requiring the assessment of the possible impairment of long-lived assets, other than by verifying that certain high-level reviews, which the Firm considered mitigating controls, had occurred.

3. Issuer I

The Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR, as follows –

- The issuer has several production and processing sites, each with multiple financial processes, and there are a substantial number of manual controls related to each process. The Firm visited two of the issuer's sites and tested one process at one of these sites. For all other processes at these two sites and for all processes at the remaining sites, the Firm used the work of the issuer's IA, and re-tested IA's work for three processes. IA identified multiple control failures, including failures at most locations, but the failures were not the same at all locations. In scoping the audit, the Firm assumed that risks and controls were the same across all locations, and therefore it reduced the number of sites at which it performed testing. These assumptions were incorrect, and, therefore the extent of the Firm's testing was insufficient.
- The Firm failed to support the extent of its use of the work of others, as it failed to obtain an understanding of control test procedures performed by IA, and it relied on work performed by IA to test important controls related to multiple processes in areas of higher risk, including inventory, revenue, and accounts receivable, without performing any independent testing or re-testing of these controls.
- The Firm considered certain of the issuer's controls selected for testing in areas of higher risk to relate to non-routine processes and certain of the controls to be highly subjective. Nonetheless, the Firm's procedures to update its tests of internal controls in these areas for the three-to six-month period between interim control testing and year end were limited to general inquiries as to whether the operation of any controls had changed.

- The Firm failed to test the valuation of the most significant component of the cost of inventory. In addition, the Firm inappropriately relied on inventory cost information obtained from a system-generated report without testing the accuracy and completeness of that report and the reconciliation of that report to the general ledger.

4. Issuer J

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR, as follows –

- The Firm failed to sufficiently test controls over the issuer's revenue recognition for certain revenue arrangements, as the Firm focused its testing on verifying that the control activity had occurred without evaluating its effectiveness, including its level of precision. Further, in certain instances, the Firm performed procedures related to the issuer's transaction processes but failed to test controls over those processes.
- The Firm failed to identify and test controls over, and to perform substantive procedures to evaluate, the issuer's accounting for competitive-pricing clauses and product discounts contained in certain customer contracts.
- The Firm's testing of revenue cut-off, including the testing of related controls, was limited to evaluating whether the shipping terms supported recognition of revenue in the period under audit. The Firm failed to consider other factors that affect revenue recognition, such as passage of title, completion of installation, and reasonable assurance of collectability.
- The Firm failed to evaluate whether service contracts and equipment sales to the same customers should be considered single arrangements for the purpose of revenue recognition.

5. Issuer K

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and the effectiveness of ICFR, as follows –

- The Firm failed to sufficiently test revenue. Specifically,
 - The Firm relied on controls over revenues but its testing of those controls was inadequate for the following reasons –
 - The Firm failed to identify and test controls over the entry of customer contract terms into the issuer's systems.
 - The Firm failed to identify and test controls over the identification and valuation of post-delivery obligations contained in multiple-element arrangements.
 - The Firm's procedures to update its testing of controls over revenue for the four-month period between its interim testing and year end were limited to general inquiries as to whether any controls had changed, despite the varying degrees of risk associated with controls in the revenue process.
 - The issuer has multi-year contracts with most of its customers, including certain contracts covering multiple products and services. The Firm failed to perform sufficient substantive procedures related to these contracts. Specifically, the Firm failed to review customer contracts for terms that could affect revenue recognition. The Firm also failed to identify the existence of multiple-element arrangements and test whether the deliverables under such arrangements should be considered separate units of accounting. In addition, the Firm failed to assess whether the issuer's policy for the timing of revenue recognition was appropriate.
- The issuer completed numerous acquisitions during the year that were accounted for as business combinations. The Firm failed to sufficiently test the

valuation of the assets acquired and liabilities assumed. Specifically,

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated, other than by inquiring of management, the reasonableness of certain significant assumptions that the issuer used, such as revenue-growth and customer-attrition rates, in determining the fair values of the assets acquired and liabilities assumed;
 - The Firm failed to test the issuer's assumptions related to the existence and valuation of non-compete agreements; and
 - The Firm failed to perform sufficient procedures to determine whether all assets acquired and liabilities assumed had been identified and valued as of the dates of the acquisitions. Specifically, the Firm's procedures were limited to testing the existence of certain accounts receivable and, for certain acquisitions, comparing the assets and liabilities to unaudited balance sheets.
- The issuer amortized certain of its intangible assets on a straight-line basis over the estimated useful lives of the assets. The Firm failed to evaluate whether the issuer's use of straight-line amortization was appropriate for these intangible assets given the issuer's future cash flow estimates, which indicated that the economic benefits of these intangible assets would not be consumed at the same rate throughout the assets' lives. In addition, in evaluating the appropriateness of the issuer's estimate of the useful lives of these intangible assets, the Firm failed to take into account certain evidence, included in the Firm's documentation of other aspects of the audit, that suggested that the useful lives were significantly shorter.

6. Issuer A

In this audit, in addition to the deficiencies described above related to the fair value measurements of, and disclosures related to, hard-to-value financial instruments, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR as follows –

- The Firm's procedures to update its tests of controls over processes related to revenue and the valuation of derivatives for the three-to-five-month period

between its interim testing and year end were limited to general inquiries as to whether any controls had changed, despite the varying degrees of risk associated with the controls, including, in some cases, high inherent risks or heightened fraud risks;

- When performing certain analytical procedures that the Firm intended to be among the important substantive tests to respond to identified fraud risks and other significant risks related to revenue, as well as to update the Firm's substantive testing from an interim date to year end, the Firm failed to develop expectations that were sufficiently precise to identify differences that may be potential material misstatements and to test the completeness and accuracy of the information used in these procedures;
- The Firm failed to test the completeness and accuracy of certain reports that it used in its control and substantive tests regarding revenue;
- The Firm failed to sufficiently test the recognition of revenue from one category of contracts, as its testing for that category of contracts did not include tests of controls or substantive procedures related to the terms of the contracts other than the contract rates; and
- The Firm used the work of management for testing certain controls, but it failed to determine which members of management had performed certain of these tests and, as a consequence, failed to evaluate the objectivity of these testers.

7. Issuer G

In this audit, in addition to the deficiencies described above related to testing the fair value measurements of, and disclosures related to, hard-to-value financial instruments, the Firm failed to obtain sufficient appropriate audit evidence to support its opinion on the financial statements for the following reasons –

- The Firm failed to sufficiently test the issuer's allowance for loan losses ("ALL"). Specifically,
 - The Firm failed to sufficiently test the historical loss factors used to calculate the ALL, as it did not test the completeness and accuracy of the

historical loss information and evaluate the reasonableness of the qualitative adjustments that the issuer made to the historical loss factors in calculating the ALL;

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of the assumptions the issuer used to determine the specific reserves on impaired loans; and
- The Firm failed to sufficiently test the completeness and accuracy of the impaired loan population, as follows –
 - The Firm failed to perform procedures to determine whether the issuer's process for identifying impaired loans was effective.
 - The issuer's independent loan review function provides a significant input into the determination that a loan is impaired, and the Firm relied on this function in its testing of the ALL. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had analyzed the scope of the loan review function's work, including its sampling methodology and the nature and extent of the review procedures it performed.

8. Issuer L

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR, as follows –

- The Firm failed to perform sufficient procedures to substantively test the issuer's ALL. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had addressed significant issues it had identified regarding 20 percent of the loans it had selected for testing.
- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the findings of the issuer's loan review function in order to reach its conclusions on the effectiveness of the controls over the issuer's loan risk-rating and identification of problem loans.

- The Firm failed to sufficiently test controls over compliance with the issuer's policy that past due balances greater than 90 days no longer accrue interest, and that past due balances greater than 180 days are charged to the allowance. Specifically, the Firm selected one loan to confirm a change to non-accrual classification, but did not verify that such change had occurred timely, and the Firm's other testing was focused on exceptions to the policy.

9. Issuer M

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR, as follows –

- The Firm failed to perform sufficient procedures to test the issuer's valuation of investment securities. Specifically,
 - The issuer valued certain of its available for sale ("AFS") securities using external data. The Firm identified as a primary control over the valuation of these securities management's review of the monthly mark-to-market adjustment of the value of these securities. The Firm failed to obtain an understanding of and evaluate the criteria management used to identify price changes for investigation and the investigation procedures performed, and to determine whether pricing exceptions were appropriately resolved. While the Firm used the work of IA to test the issuer's interface with its external provider of valuation data, the Firm did not investigate differences that IA had identified (but had not investigated) through its test of sample items, and it also failed to test any controls over the automated interface;
 - To substantively test the valuation of the portfolio, the Firm selected seven AFS securities. These seven securities represented only a small portion of the AFS portfolio priced externally, and included only two of the several types of securities that the issuer held. In addition, for one of the selections, the Firm failed to evaluate a significant difference between the recorded price and the price it obtained from an external pricing service; and

- The Firm tested the valuation of certain securities as of a date five months before year end. The Firm's procedures to update this testing were limited to noting changes in the balance due to maturities, purchases, sales, and mark-to-market adjustments.

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 processes related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following six 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 and 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



PCAOB Release No. 104-2011-319A
Inspection of Ernst & Young LLP
November 30, 2011
Page 17

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 contains a discussion of criticisms of and potential defects in the Firm's quality control system.^{23/} 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 identified deficiencies in audit performance. These deficiencies, whether alone or when aggregated, may indicate respects in which a firm's system has failed to assure quality in the performance of engagements. 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 similar deficiencies, may indicate a significant defect in a firm's quality control system even when the deficiency has not resulted in an insufficiently supported audit opinion. In addition, reviews specifically focused on aspects of a firm's system of quality control may indicate a significant defect in that system.

As described below, an analysis of the inspection results reported by the inspection team indicates that the Firm's system of quality control requires remedial action in order to provide sufficient assurance that the Firm's audit work will meet applicable standards and requirements.

* * * *

Deficiencies in or Affecting the Engagement Quality Review ("EQR") Process

The engagement reviews also indicate quality control deficiencies related to the Firm's EQR process. The inspection team identified four audits,^{24/} all of which are discussed in Part I.A, where the EQR process was deficient * * * *:

^{23/} This report's description of quality control issues is based on the inspection team's observations during the primary inspection procedures. Any changes or improvements that the Firm may have made in its system of quality control since that time may not be 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.

^{24/} Issuer G, H, I, and K

- Inadequate EQR Review

The inspection of the four audits noted above indicate that the EQR partners were not appropriately evaluating significant judgments and related conclusions, and were not performing reviews at a sufficient level of rigor and detail. For example, in one audit included in Part I.A,^{25/} the EQR partner failed to review certain work papers that the engagement team identified within the Firm's EQR work program as significant and that the EQR partner should review. In two other audits included in Part I.A,^{26/} the EQR partners failed to identify that the engagement team incorrectly used the Firm's "representative site" scoping approach, even though audit scoping was a part of the EQR partners' reviews. Further, in another audit,^{27/} the EQR partner failed to evaluate whether the engagement team had obtained sufficient evidence given that the memorandum from the Firm's internal specialist that the EQR partner reviewed included matters that should have been identified and resolved.

* * * *

* * * * The Firm has established a process to hold the EQR partners accountable for quality occurrences. The Firm has also provided additional guidance and training to reinforce the implementation of the new guidance. The Firm should (1) establish a process to monitor the effectiveness of these actions, beyond simply relying on the internal inspection results, and (2) evaluate whether there may be other root causes that may be contributing to the deficiencies in the EQR process, and design the appropriate corrective actions to respond to any additional root causes.

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^{25/} Issuer K

^{26/} Issuers H and I

^{27/} Issuer G

Failure to Evaluate Contrary or New Evidence

The inspection results indicate that the Firm, in certain instances, relied heavily on evidence that supported the issuer's conclusion, without sufficiently taking into account new or contrary evidence that was available to the Firm at the time of the audit. This tendency frequently contributed to the concerns noted in prior inspection reports related to a lack of professional skepticism and deficiencies in auditing estimates.

In five audits inspected in 2010,^{28/} including one that is discussed in Part I.A of this report,^{29/} the Firm's evaluation of management's estimates related to a significant account appeared not to take into account contrary information, or was performed without determining whether new information had arisen that had a bearing on the estimates. In three of these audits,^{30/} the Firm supported its conclusions without considering recent events or current-year transactions or whether new information existed that was contrary to the issuer's position.

These deficiencies indicate that some of the Firm's professionals may lack professional skepticism when new or contrary information is identified, or when considering whether recent events (such as current economic conditions) or current-year transactions may constitute such contrary information. The deficiencies may result, in part, from the Firm's professionals placing too much reliance on their perceived knowledge of the issuer obtained during the course of their tenure on the engagement.

* * * * The Firm should monitor the effectiveness of its action plan. In addition, given the recurring high rate of deficiencies that can be attributed, at least in part, to a lack of professional skepticism, the Firm should take steps to further understand why some engagement teams lack professional skepticism, and take specific action steps to institute additional corrective measures as appropriate.

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^{28/} Issuers K, P, S, X, and Y

^{29/} Issuer K

^{30/} Issuers P, S, and Y

APPENDIX C

THE INSPECTION PROCESS FOR ANNUALLY INSPECTED FIRMS

The inspection process is designed, and inspections are performed, to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. This appendix describes the inspection process for those annually inspected firms that have multiple practice offices and a national office structure. While this appendix describes the general inspection process applied in the 2010 inspections of these firms, the process was customized to each firm's inspection, bearing in mind the firm's structure, past inspection observations, observations during the course of the 2010 inspection, and other factors. Accordingly, procedures described in this Appendix, while generally applicable to annual inspections, may not have been applied, or may not have been applied fully, in the inspection of any individual firm, and additional procedures, not described in this appendix, may have been applied in the inspection of an individual firm.

The inspection process included reviews of aspects of selected issuer audits completed by the inspected firm. These reviews were intended both to identify deficiencies, if any, in those aspects of the audits and to determine whether those deficiencies indicated weaknesses or defects in 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

Inspections include reviews of aspects of selected audits of financial statements and ICFR. For each audit selected, the inspection team reviewed certain of the issuer's SEC filings. The inspection team selected certain aspects of the audits for review and inspected the engagement team's work papers and interviewed engagement personnel regarding those aspects. 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 and, for some engagements, the inspection team 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 was allowed the opportunity to provide a written response to the comment form.

2. Review of Firm Management and Monitoring Processes Related to Audit Quality Control

The inspection team's review of a firm's system of quality control was intended to provide a basis for assessing whether that system was appropriately designed and implemented to achieve the goal of conducting audits that are in compliance with applicable standards. This review included an 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

Procedures in this area were designed to focus on (a) 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) whether actions and communications by the firm's leadership – the "tone at the top" – demonstrate a commitment to audit quality. The inspection team interviewed members of the firm's leadership to obtain an understanding of any significant changes in the firm's approach to, and processes for, its management, including the mechanisms, formal or informal, that assess, monitor, or affect audit performance. The inspection team also reviewed significant management reports and documents, as well as information regarding financial metrics and the budget and goal setting processes that the firm uses to plan for, and evaluate the success of, its business.

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

Procedures in this area were designed to focus on (a) whether the firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the

firm; (b) the firm's processes for allocating its partner resources; and (c) 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 also reviewed documentation related to certain of these topics. In addition, the inspection team's interviews of audit partners included questions regarding their responsibilities and allocation of time and the interviews of firm management included the performance of partners being inspected, the evaluation and compensation process, any disciplinary actions, and any situations where a client requested a change in the lead audit partner. In addition, the inspection team reviewed a sample of partners' personnel files, including files of partners who resigned or took early retirement 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 inspection team selected certain issuer audits to (a) evaluate compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the client and (b) observe whether the audit procedures were responsive to the risks identified during the process.

- 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 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. In some cases, the inspection team also reviewed, on a limited basis, certain of the audit work performed by the firm's foreign affiliates on the foreign operations of U.S. issuer clients.

- 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

Procedures in this area were designed to identify and assess the monitoring processes that the firm uses to monitor audit quality for individual engagements and for the firm as a whole. The inspection team interviewed members of the firm's management and reviewed documents regarding 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 its results to those from the internal inspection.

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

The inspection team reviewed steps the firm has taken in the past several years to address possible quality control deficiencies. The inspection team then assessed the design and evaluated the 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

The inspection team assessed 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 policies and procedures, and interviewed firm management to consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

APPENDIX D

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.^{31/}

^{31/} 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.

Ms. Helen Munter
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

November 18, 2011

Response to Part I of the Draft Report on the 2010 Inspection of Ernst & Young LLP

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") regarding Part I of the Draft Report on the 2010 Inspection of Ernst & Young LLP (the "Report").

Our overriding objective is to make certain that all aspects of our auditing and quality control processes are of the highest quality and continue to benefit the capital markets in which investors participate. Overall, we believe the PCAOB's inspection process assists us in identifying areas where we can continue to improve our performance.

We have thoroughly evaluated all matters described in Part I - Inspection Procedures and Certain Observations of the Report. Although we do not agree with the specific characterization of the work we performed in all cases, on an overall basis we do agree with certain findings in the Report and, where applicable, have taken actions to address such findings in accordance with EY policies and PCAOB standards. With respect to certain findings raised in Section A.1¹ under the caption *Deficiencies in Testing the Fair Value Measurements and Disclosures of Financial Instruments Without Readily Determinable Fair Values* and for Issuer M, we believe the totality of the audit work performed on these engagements permitted us to conclude, with reasonable assurance, that we obtained sufficient appropriate audit evidence to support our opinions on the financial statements and the effectiveness of internal control over financial reporting. Notwithstanding our differing views on these specific engagements, we wish to highlight our understanding of the issues being raised by the Board more generally on the important topic of auditing financial instrument fair value measurements and disclosures and we have enhanced portions of our guidance in this area. Such enhancements are effective for our 2011 audits.

We appreciate the opportunity to provide our response to the Report and look forward to continuing to work with the PCAOB on matters of interest to our public company auditing practice.

Respectfully submitted,

Ernst & Young LLP

¹ Issuer B, C, D, E and F