

**Report on**  
**2011 Inspection of PricewaterhouseCoopers LLP**  
**(Headquartered in New York, New York)**

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

**September 27, 2012**

**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 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 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 financial statement misstatements, including failures to comply with 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 apparent misstatements 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 whether an issuer's financial statements are misstated or fail to comply with Commission disclosure requirements, rests with the Commission. Any description, in this report, of financial statement misstatements or failures to comply with 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.



## 2011 INSPECTION OF PRICEWATERHOUSECOOPERS LLP

### Preface

In 2011, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm PricewaterhouseCoopers LLP ("PwC" 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.<sup>1/</sup> 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 annual inspected firms.<sup>2/</sup> Appendix D includes the Firm's comments, if any, on a draft of the report.<sup>3/</sup> 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.

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<sup>1/</sup> 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.

<sup>2/</sup> 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.

<sup>3/</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.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.<sup>4/</sup> 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 a reviewed audit 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.<sup>5/</sup> 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.

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<sup>4/</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>5/</sup> 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 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. 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 inspection staff ("the inspection team") conducted primary procedures for the inspection from April 2011 to January 2012. The inspection team performed field work at the Firm's National Office and at 28 of its approximately 60 U.S. practice offices.

#### A. Review of Audit Engagements

The 2011 inspection of the Firm included reviews of aspects of 60 audits performed by the Firm and reviews of the Firm's audit work on three other issuer audit engagements 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 work it reviewed. Those deficiencies included failures by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,<sup>6/</sup> as well as failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures. In some instances, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices.

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.<sup>7/</sup>

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<sup>6/</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 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.

<sup>7/</sup> PCAOB Auditing Standard ("AS") 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

Three of the deficiencies described below relate to auditing aspects of the issuers' financial statements that the issuers either restated or announced an intention to restate after the primary inspection procedures.<sup>8/</sup>

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, certain of the identified deficiencies were of such significance that it appeared 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"). In addition, one of the identified deficiencies, which occurred in an audit in which the Firm played a role but was not the principal auditor, was of such significance that it appeared that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audit. The audit deficiencies that reached these levels of significance are described below.<sup>9/</sup>

A.1. Issuer A

In this audit, the Firm failed to perform sufficient procedures to evaluate whether the issuer's investment in another entity was accounted for properly. Specifically, the Firm failed to perform any procedures, beyond inquiry of management and reading an issuer-prepared memorandum, to evaluate the issuer's conclusion that its investment in the entity should be accounted for on the cost method.

In addition, the Firm failed to perform sufficient procedures to test the valuation of the issuer's investment in, and receivables from, this entity. Specifically, the Firm failed

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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>8/</sup> The Board inspection process did not include review of any additional audit work related to the restatements and adjustments.

<sup>9/</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.

to perform procedures, beyond inquiry of management, to evaluate the issuer's conclusion that its investment in, and receivables from, this entity were not impaired, even though the Firm's work papers included a number of potential impairment indicators, including indications that the entity lacked sufficient cash to fund its operations for the next 12 months.

A.2. Issuer B

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- The issuer discontinued production of a significant product line during the prior year and introduced a new product line to replace it. There were no sales of the discontinued product line during the last nine months of the year under audit. The issuer calculated a separate reserve for this product line based on factors and assumptions that were specific to this product line. The Firm failed to test, beyond inquiry, the significant assumptions management used to calculate this separate reserve, which was approximately one-third of the recorded value of the product inventory.
- The Firm identified revenue and accounts receivable as significant accounts. The Firm used the issuer's internal audit group to test whether revenue recorded near year end was recorded in the appropriate period ("cut-off"), and also to test the subsequent cash receipts for accounts receivable for which confirmations were not returned. The Firm, however, failed to appropriately supervise the work of the internal auditors, as the internal auditors independently selected the transactions for the cut-off testing, and the Firm did not direct or test any of the work performed by the internal auditors in these areas.

A.3. Issuer C

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

- The Firm failed to perform sufficient procedures to test the controls related to the issuer's process for determining whether a legal entity is a variable interest entity ("VIE") and, if so, whether it needed to be consolidated. Specifically, the issuer engaged an external consultant to assist with the implementation of the new accounting standard related to the consolidation of VIEs. The issuer also engaged the same external consultant to perform its internal audit function, including the testing of internal controls related to the issuer's process for analyzing legal entities based on the new accounting standard. The Firm used the work of the external consultant to reduce the extent of its testing of internal controls in this area, but there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed the effect of the consultant's services on the consultant's objectivity.
- The Firm failed to test the completeness of the list of VIEs that the issuer used in determining which VIEs should be consolidated after the initial adoption of the new accounting standard.
- For certain financial instruments without readily determinable fair values ("hard-to-value financial instruments"), when the issuer's standard model produced fair value measurements that the issuer considered to be unreasonable, the issuer developed its fair value measurements using assumptions based on certain transactions that had occurred in the first quarter of the prior year. In addition, for certain of these financial instruments, when the issuer expected losses to be realized, the issuer adjusted the fair value measurement based, in part, on the performance of the underlying collateral. The Firm failed to perform sufficient procedures to test the fair value measurements of these financial instruments and the related controls in the following respects –
  - The Firm selected for testing certain review controls over the issuer's valuation of the financial instruments, but failed to sufficiently test the controls. Specifically, the Firm's testing of the operating effectiveness of these controls was limited to obtaining evidence that such reviews had occurred and comparing management reports to other information that was prepared by the issuer and not otherwise subject to controls testing.



- The Firm tested certain of the hard-to-value financial instruments that were valued based in part on the performance of the underlying collateral, but it failed to test whether the issuer's population of financial instruments that should have been valued using this method was complete. The Firm also failed to identify and test any controls related to the issuer's identification of these financial instruments.
- The Firm relied on certain review controls over the issuer's valuation of certain loss reserves, but failed to perform sufficient procedures to test these controls. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested the operating effectiveness of these controls beyond obtaining evidence that such reviews had occurred.

A.4. Deficiencies in Testing the Fair Value Measurements and Disclosures of Financial Instruments without Readily Determinable Fair Values

In eight audits,<sup>10/</sup> due to deficiencies in testing the fair value measurements of, and the disclosures related to, hard-to-value financial instruments, including certain municipal bonds, asset-backed securities, collateralized mortgage obligations, other mortgage-backed securities, and credit default swaps, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions. The deficiencies related to the audits of issuers C and D are described separately in Parts I.A.3 and I.A.5. The deficiencies in the other six audits are as follows –

- In four of these audits,<sup>11/</sup> the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying fair value measurements that were obtained from pricing services or other third parties and used in the Firm's testing of the fair value of certain of the hard-to-value financial instruments.

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<sup>10/</sup> Issuers C, D, E, F, G, H, I, and J

<sup>11/</sup> Issuers E, F, G, and H

- In one of these audits,<sup>12/</sup> the Firm failed to test certain significant inputs used by the issuer to determine its fair value measurements for certain hard-to-value financial instruments.
- In two of these audits,<sup>13/</sup> the Firm failed to sufficiently test the issuers' disclosures of certain hard-to-value financial instruments as level 2 or level 3 in the fair value hierarchy set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurements and Disclosures*. Specifically, the Firm failed to obtain an understanding of whether the financial instruments were valued using significant inputs that were observable or unobservable.
- In two of these audits,<sup>14/</sup> the Firm failed to perform any substantive procedures to test the year-end fair value measurements of certain groups of hard-to-value financial instruments.
- In one of these audits,<sup>15/</sup> the Firm failed to perform sufficient procedures to test the fair value measurements of certain hard-to-value financial instruments for which it had requested, but not received, a price from pricing services. Specifically, the Firm's procedures for these financial instruments were limited to comparing the issuer's recorded price for one of these financial instruments to pricing information from the same source that the issuer had used.
- The Firm failed to evaluate, or sufficiently evaluate, the implications of significant differences in fair value measurements from different sources for individual financial instruments. Specifically –

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<sup>12/</sup> Issuer E

<sup>13/</sup> Issuers H and I

<sup>14/</sup> Issuers E and J

<sup>15/</sup> Issuer F

- In three audits, for certain hard-to-value financial instruments, the Firm obtained multiple prices and used the price closest to the issuer's recorded price in testing the fair value measurements. In one of these audits,<sup>16/</sup> the Firm failed to evaluate the implications of the significant differences between the other prices obtained and the issuer's prices. In the second audit,<sup>17/</sup> the Firm failed to sufficiently evaluate the implications of the significant differences between the other prices obtained and the issuer's prices, as it limited its evaluation to certain of the largest differences. In the third audit,<sup>18/</sup> the Firm limited its evaluation of the significance of the differences between the other prices obtained and the issuer's prices to inquiring of management regarding differences over an established threshold.
  
- In one audit,<sup>19/</sup> the issuer used two valuation methods when determining the fair value measurement for a portfolio of hard-to-value financial instruments. The issuer based its recorded value on one of these methods and used the second method to test the recorded fair value measurements. For one portion of the portfolio, the Firm tested the fair value measurements that the issuer determined using the second method. The Firm failed to evaluate the implications of the significant differences in the fair value measurements resulting from the two methods for these financial instruments. For the other portion of this portfolio, the Firm failed to test the fair value measurements determined by the issuer.

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<sup>16/</sup> Issuer G

<sup>17/</sup> Issuer H

<sup>18/</sup> Issuer I

<sup>19/</sup> Issuer E

A.5. Issuer D

The audit report on the consolidated financial statements of this issuer was issued by a foreign affiliate of the Firm, and the Firm played a substantial role in the audit. The Firm failed to perform sufficient procedures to test the fair value measurements of certain hard-to-value financial instruments and the related controls. Specifically –

- The Firm tested the fair value measurements of certain hard-to-value financial instruments by developing, for each type of financial instrument, a single fair value measurement, and then comparing the fair value measurement developed by type to the issuer's recorded values for each of the various individual financial instruments of that type. The Firm's approach was insufficient in the following respects –
  - The Firm failed to consider many of the specific characteristics of the individual financial instruments, including the performance of the collateral underlying certain of the financial instruments, when developing its single fair value measurement by type of financial instrument. Further, the Firm identified a hard-to-value financial instrument with certain characteristics related to the underlying collateral that were different from the characteristics that generally existed for that type of financial instrument. These unique characteristics significantly affected the fair value measurement of the financial instrument, but the Firm failed to perform any additional procedures to determine whether similar characteristics existed in other financial instruments.
  - In developing its independent fair value estimates for certain of these types of hard-to-value financial instruments, the Firm applied discounts to certain market data. The Firm, however, failed to perform procedures to evaluate whether these discounts were reasonable.
- The Firm failed to obtain an understanding of the specific methods and assumptions underlying certain fair value measurements that it obtained from pricing services or other sources and used in its testing of the fair value measurements of certain hard-to-value financial instruments.

- The Firm failed to perform sufficient procedures to test the controls over the valuation of certain hard-to-value financial instruments. Specifically –
  - The Firm identified that the issuer personnel performing the price verification control for these financial instruments used market information obtained from one of the issuer's traders. The Firm, however, failed to evaluate whether the information the trader provided was reflective of market conditions and was therefore reliable for use in the control.
  - For certain of the financial instruments the Firm selected to test the price verification control, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested, beyond inquiry of management, whether the significant valuation assumptions used in the performance of the price verification control were supported.

A.6. Issuer E

In this audit, in addition to the deficiencies described in Part I.A.4 related to testing the fair value measurements of, and disclosures related to, hard-to-value financial instruments, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and the effectiveness of ICFR –

- The Firm failed to sufficiently test the issuer's allowance for loan losses ("ALL"). Specifically, the Firm failed to evaluate, beyond inquiring of management and reading regulatory examination reports, a significant assumption used to develop the formula-driven component of the issuer's ALL for homogenous loans. In addition, for certain of these loans, the Firm failed to perform substantive procedures, beyond inquiry of management, to test the assumptions management used to develop a judgmental component of the ALL.
- The Firm failed to evaluate the reasonableness of certain assumptions underlying the issuer's methodology that the issuer used in its goodwill impairment analysis. In addition, the Firm failed to sufficiently evaluate the

reasonableness of the overall implied control premium that the issuer used in its fair value calculations. Specifically, the overall implied control premium significantly exceeded the control premiums for the individual reporting units and the Firm failed to test the reasonableness of this difference.

- The Firm failed to sufficiently test the completeness and valuation of a loss contingency reserve. Specifically, the Firm failed to identify and test any controls to ensure that all claims were entered into the issuer's system and if so, that they were entered in a timely manner. In addition, the Firm failed to test, beyond inquiry of management, significant assumptions the issuer used to estimate certain other components of this reserve.

A.7. Issuer K

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

- The Firm failed to sufficiently test the valuation of inventory and the related controls. Specifically, the Firm failed to test certain significant assumptions the issuer used to value inventory and failed to identify and test any controls over one of these assumptions.
- The issuer's controls over inventory included the performance of physical inventory counts for approximately half of its retail inventory locations at an interim date and for the remaining locations at dates near year end. For the locations where inventory was counted at interim dates, the Firm tested the operating effectiveness of this control and performed physical inventory observations at a sample of the locations. With respect to these locations, the Firm failed to perform roll-forward procedures in order to extend its conclusion on the existence and completeness of inventory to year end. In addition, the Firm failed to identify and test any controls over the issuer's inventory roll-forward processes for these locations.
- The Firm failed to perform procedures to test the existence of the issuer's inventory held at non-retail locations.

- The Firm failed to test the completeness and accuracy of the data used to calculate one of the issuer's significant categories of income. In addition, the Firm failed to sufficiently test liabilities associated with this income. Specifically, the Firm's planned approach to audit these liabilities included the performance of substantive analytical procedures. The Firm, however, failed to obtain evidence that a plausible and predictable relationship existed between its expectations and the recorded amounts.

A.8. Issuer L

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

- The Firm failed to sufficiently test an important entity-level control over revenue. Specifically, the Firm failed to test, beyond inquiry of management, the issuer's investigation of variances identified during the operation of this control, and failed to evaluate whether the control operated at a level of precision that would prevent or detect misstatements that could be material.
- During the year, the issuer acquired a service organization that, both before and after the acquisition, processed transactions and provided data that the issuer used to calculate revenue, accounts receivable, and accounts payable for one of its significant locations. The Firm obtained and relied on a service auditor's report regarding the design and operating effectiveness of controls at the service organization for the first nine months of the year, which included several months after the issuer had acquired the service organization. The Firm failed in the following respects to perform sufficient procedures regarding the controls at the service organization for the period from the date of the acquisition through the issuer's year end. The Firm failed to assess the competence and objectivity of the individuals from the service auditor who performed the testing of controls, and the Firm failed to evaluate and test their work for the period after the acquisition. In addition, the Firm failed to perform sufficient procedures to extend its conclusions regarding the controls at

the acquired company to the issuer's year end, as it limited its procedures to inquiry of the acquired company's management.

- The Firm failed to sufficiently test revenue. Specifically –
  - As a result of the deficiencies in testing controls that are discussed above, the Firm did not have a sufficient basis for its reliance, when performing its tests of revenue, on the information provided by the service organization after the acquisition.
  - The Firm's approach to testing one of the issuer's categories of revenue included testing the largest revenue transactions in order to achieve certain levels of coverage. The Firm failed to perform substantive testing on the remaining population of transactions, which totaled approximately one-third of this category of revenue and was many times the Firm's established materiality level.
  - The Firm planned to perform substantive analytical procedures to test another category of revenue that represented approximately ten percent of the issuer's consolidated revenue. The Firm, however, failed to establish appropriate expectations, because one of the significant inputs used to develop the expectations was based solely on (a) for one quarter, the responses to inquiries of management and (b) for later quarters, the issuer's results for prior quarters within the year under audit, which had been tested only through these analytical procedures.
- In testing the issuer's accounting for certain business combinations, the Firm failed to test the fair value of certain significant assets acquired and liabilities assumed.

A.9. Issuer M

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



- The Firm failed to perform procedures, beyond inquiry of management, to test that the issuer's inventory was recorded at the lower of its cost or market.
- The Firm failed to perform sufficient procedures to test controls over certain adjustments made to the recorded value of inventory. Specifically, the Firm limited its testing of the control it selected to determining whether those approving the adjustments had the authority to do so, and it failed to test whether the control addressed the completeness and accuracy of the adjustments.
- The Firm failed to perform sufficient procedures to test an important control over the completeness and existence of revenue. Specifically, the Firm's testing of only one instance of the control was insufficient to conclude on the operating effectiveness of the manual components of the control.

A.10. Issuer N

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

- For certain of the issuer's locations that represented approximately half of its revenue, the Firm's planned approach for auditing revenue included reliance on controls, the performance of substantive analytical procedures, and tests of details for a sample of transactions that exceeded a certain defined monetary threshold.

The Firm failed to sufficiently test controls over revenue. The Firm identified three controls related to revenue. One of these controls consisted of management's review of segment financial results and key performance indicators. The Firm failed to sufficiently test the control to determine whether it was operating at a level of precision that would prevent or detect a misstatement that could be material to the financial statements, as the Firm's testing was limited to determining that the review had occurred. For the second control, the Firm used the work of

management, but failed to assess the competence and objectivity of management in order to have a basis for using this work. The third control addressed only the completeness of revenue.

In performing its analytical procedures, the Firm developed its expectations based on the issuer's budget, but failed to test the effectiveness of management's process for developing the budget. Further, the Firm failed to obtain corroboration of management's explanations of significant differences between the expected and actual revenues. Due to these deficiencies, the analytical procedures provided little to no substantive assurance. As a result, for those transactions below the monetary threshold the Firm had established for its tests of details, the Firm failed to reduce audit risk with respect to revenue to an appropriately low level. Specifically, the Firm limited any other testing related to those transactions to the procedures it performed in connection with related balance sheet and income statement accounts and its testing of certain journal entries. Transactions below the monetary threshold represented approximately 40 percent of the issuer's revenue for the year.

- The issuer prepared cash flow projections that it used in its annual analysis of the possible impairment of goodwill. The projections included significant growth rates for two of its reporting units. The Firm, however, failed to perform procedures, beyond inquiring of management and tracing the projected amounts to issuer documents, to assess whether the projected growth rates were reasonable.

A.11. Issuer O

In this audit of a new client, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and the effectiveness of ICFR –

- For certain of the issuer's units that in the aggregate presented a reasonable possibility of material misstatement, the Firm's approach to testing the controls over revenue, accounts receivable, allowance for doubtful accounts, and inventory was to identify and test certain entity-level controls. The Firm, however, failed to obtain evidence that these controls were designed or operating at a level of precision that would

prevent or detect a misstatement that could be material. Further, the Firm failed to perform substantive procedures at these units to test revenue, accounts receivable, allowance for doubtful accounts, and inventory. In addition, the Firm identified a specific risk of fraudulent journal entries, but failed to include journal entries recorded in the general ledgers of these units in its population of journal entries subject to testing.

- For one of the issuer's units, the Firm assessed controls over revenue as effective and tested all revenue transactions over a certain monetary threshold. With respect to revenue transactions below that threshold that were recorded throughout the year, the Firm failed to reduce audit risk with respect to revenue to an appropriately low level. Specifically, the Firm limited any testing related to those transactions to the procedures it performed in connection with related balance sheet and income statement accounts and its testing of certain journal entries. Revenue from the transactions below the monetary threshold for this unit represented approximately 95 percent of the revenue for this unit, and was many times the Firm's established materiality level.
- In testing the issuer's accounting for certain business combinations completed during the year, the Firm used the work of an external valuation specialist retained by the issuer. The Firm, however, failed to sufficiently test certain of the data and assumptions that management provided to the specialist for use in the determination of the fair value of acquired core technology, in-process research and development, customer relationships, and trade names, as well as the fair value of the issuer's contingent consideration related to the acquisitions. Specifically, the Firm failed to test, beyond inquiry of management, the forecasted cash flows, customer attrition rates, and management's assessment of the probability of achieving certain milestones.

#### A.12. Issuer P

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

- The Firm failed to identify and test any controls that addressed the accuracy of the billing rates used for the majority of the issuer's revenue transactions, other than a control that addressed only the risk of understatement of billing rates. In addition, the Firm failed to obtain a sufficient understanding of the design of an important review control over the accuracy of hours billed, as it failed to obtain an understanding of how exceptions were identified and resolved. Further, the Firm planned to use a benchmarking strategy with respect to controls over the completeness and accuracy of reports used in controls over revenue transactions. The Firm, however, did not execute an effective benchmarking strategy, as it failed to identify the applications that generated the reports and to determine whether there were any modifications to those applications during the year.
- For certain of the issuer's locations that in the aggregate presented a reasonable possibility of a material misstatement, the Firm relied on an entity-level control over the issuer's primary category of revenue. The Firm failed to test, beyond inquiry of management, this entity-level control. In addition, the Firm failed to perform substantive procedures to test the issuer's primary category of revenue and the related cost of sales at these locations.

A.13. Issuer Q

The Firm's planned approach for auditing the issuer's revenue at two business units included performing substantive analytical procedures and testing sales cut-off. The Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- With respect to certain of the analytical procedures, the Firm failed to establish that the inputs that it used to calculate its expectations had a plausible and predictable relationship to the recorded amounts. In addition, when establishing its thresholds for investigation of significant differences between the recorded and expected amounts, the Firm failed to consider the possibility that a combination of misstatements could aggregate to an unacceptable amount. As a result, the aggregated uninvestigated differences exceeded the Firm's established materiality

level for each business unit by a significant amount. Further, the Firm failed to obtain corroboration of management's explanations for most of the differences above its thresholds.

- The Firm had identified a risk of fraud related to improper revenue recognition due to sales cut-off issues. The Firm, however, did not perform any substantive tests for sales cut-off.

A.14. Issuer R

After the Firm issued its report on ICFR, the issuer identified a material weakness. The Firm failed to identify that the conditions that constituted the material weakness had existed as of the issuer's year end covered by the Firm's report.

A.15. Issuer S

The Firm failed to identify a control deficiency related to the issuer's improper accounting for an equity-method investment and evaluate whether it, individually or in combination with other control deficiencies, represented a material weakness.

A.16. Issuer T

In this audit, the Firm's planned approach for auditing revenue included reliance on internal control, substantive procedures for the related balance sheet accounts, and the performance of substantive analytical procedures. These analytical procedures, however, provided little to no substantive assurance, as the Firm failed to obtain corroboration of management's explanations of significant unexpected differences between expected and actual amounts.

A.17. Issuer U

In this audit, the Firm's planned approach for auditing gross revenue included the performance of substantive analytical procedures. The analytical procedures for the majority of gross revenue, however, provided little to no substantive assurance. Specifically, the Firm failed to appropriately develop expectations, as the expectations were developed for net revenue, which included estimated returns and other adjustments, rather than for gross revenue, to which the Firm compared its expectations. As a result, the Firm failed to identify certain differences that were in

excess of its threshold for investigation. In addition, the Firm failed to investigate one of the significant differences that it had identified.

A.18. Issuer V

In this audit, the Firm's planned approach to testing revenue included reliance on internal control, substantive procedures for the related balance sheet accounts, tests of sales transactions that either exceeded a certain monetary threshold or met certain risk-based criteria, and the performance of disaggregated analytical procedures. The Firm failed to sufficiently test the majority of the sales transactions selected for testing, as it failed to test the completeness and accuracy of certain of the data that it obtained from the issuer and used in its tests of those transactions. Further, when performing its disaggregated analytical procedures to test the population of sales transactions not covered by the above procedures, the Firm failed to test the completeness and accuracy of certain of the data that it obtained from the issuer and used to establish its expectations.

A.19. Issuer W

In this audit, the Firm assessed controls over revenue as effective and tested all domestic revenue transactions over a certain monetary threshold. With respect to domestic revenue transactions below that threshold that were recorded throughout the year, the Firm failed to reduce audit risk with respect to revenue to an appropriately low level. Specifically, the Firm limited any testing related to those transactions to the procedures it performed in connection with related balance sheet and income statement accounts and its testing of certain journal entries. Revenue from the transactions below the monetary threshold represented approximately 95 percent of the issuer's domestic revenue for the year, and was many times the Firm's established materiality level.

A.20. Issuer X

In this audit, with respect to one category of revenue, the Firm assessed controls over revenue as effective and tested all revenue transactions over a certain monetary threshold. With respect to revenue transactions below that threshold that were recorded throughout the year, the Firm failed to reduce audit risk with respect to revenue to an appropriately low level. Specifically, the Firm limited any testing related to those transactions to the procedures it performed in connection with related balance sheet and income statement accounts and its testing of certain journal entries. Revenue from

the transactions below the monetary threshold represented approximately 90 percent of the revenue for this category for the year, and was many times the Firm's established materiality level.

A.21. Issuer Y

In this audit of a new client, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. Specifically, the issuer processed inventory transactions using two information technology ("IT") applications for one location. The Firm relied on IT general controls ("ITGCs") and application controls at this location, but failed to test these controls (other than a few aspects of ITGCs that were tested at an entity level).

For a third IT application that processed revenue and inventory transactions for another location, the Firm used the work of the issuer's internal auditors to test ITGCs (other than a few aspects of ITGCs that were tested at an entity level), certain application controls, and a control over the entry of contract information into this IT application. The Firm, however, failed to obtain an understanding of the specific procedures performed by the internal auditors, including the sample sizes tested. Further, other than controls over the cut-off of revenue and adjustments to revenue, and the controls tested by the internal auditors as noted above, the Firm failed to test any controls over the completeness, valuation, and existence of revenue that was processed by this application even though it relied on controls over such processing.

For both locations, the Firm failed to test controls over the process used to determine the standard costs of individual items in inventory.

A.22. Issuer Z

An issuer asserted that a foreign subsidiary's earnings were permanently reinvested outside of the U.S. and therefore did not include those earnings in its U.S. taxable income. During the year, however, the foreign subsidiary transferred significant amounts of cash to a U.S. subsidiary of the issuer. While an agreement existed between the two entities under which the foreign subsidiary would have been able to transfer certain amounts to the U.S. subsidiary without incurring taxes, the Firm failed to test whether the foreign subsidiary's cash transfers were in excess of the amounts allowed under the agreement, and therefore may have been taxable in the U.S.

**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 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





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

## **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 2011 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 2011 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.

2.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.

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

Procedures in this area 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.

2.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.

2.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.

2.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

2.e.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.

2.e.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.

2.e.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.<sup>20/</sup>

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<sup>20/</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.



August 1, 2012

Helen Munter, Director  
Division of Registration and Inspections  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006

**Re: Response to Draft Report on the 2011 Inspection of PricewaterhouseCoopers LLP**

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Draft Report on the 2011 Inspection of our Firm's 2010 audits (the "Report").

We continue to support the PCAOB's mission, which is to "protect the interests of investors and further the public interest through the preparation of informative, accurate and independent audit reports" and we value the insights provided by the PCAOB's inspection process. The execution of quality audits in full compliance with the PCAOB standards has been and remains the top priority for our practice. On behalf of our Firm and its leadership, we are committed to addressing the issues identified in the Report in a diligent, conscientious and thoughtful manner.

We believe that as with any audit process, judgments are necessarily involved in the inspection process and professionals can reach different conclusions about the adequacy of audit evidence in a particular circumstance. In those instances where such differences exist related to the inspection observations detailed in this Report, they generally related to the significance of the observation in relation to the audit evidence taken as a whole rather than the specific nature of the observation. So, while we may disagree with the significance of inspection observations in certain cases, we have taken all of the Board's observations into account in formulating our plan to continuously improve audit quality.

We have evaluated each of the observations set forth in *Part I - Inspection Procedures and Certain Observations* of the Report and taken appropriate actions under both PCAOB standards and our policies. Our evaluation included those steps that we considered necessary to comply with AU 390, *Consideration of Omitted Procedures After the Report Date*, and where applicable, AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditors Report*.

Over the past several months, we have made significant investments and taken many actions to improve audit quality. Beyond the actions we have already taken, our process for monitoring and improving audit quality is continuous, and we will continue to identify and respond to opportunities to enhance audit quality. The following summary, while not exhaustive, describes some of our partners' more recent efforts in this regard:

- Investing significant amounts of time and attention of Firm leadership in understanding, evaluating and implementing actions designed to support achievement of our quality initiatives



- Establishing 140 incremental partner and manager roles in our new Assurance Quality and Transformation Organization, a quality-focused organization which encompasses all of our quality support functions - providing for experienced leadership, coordination, oversight and monitoring of all of our audit quality initiatives
- Utilizing experienced partners from the Assurance Quality and Transformation Organization to provide on-the-ground support to engagement teams and reinforce the implementation of new audit methodology guidance focused on areas of more frequent inspection observations
- Adjusting our staff utilization targets to provide greater capacity and increased focus on audit quality - hiring approximately 1,200 experienced audit professionals over the past year
- Enhancing the partner compensation and evaluation process to reinforce the responsibilities and accountability for audit quality with our partners and leaders - clarifying the responsibilities for quality at all levels of leadership and strengthening the emphasis on quality in our partner development plans
- Reinforcing and rewarding audit quality within the staff development, evaluation and compensation process - establishing a new bonus compensation program tied to Firm-wide audit quality benchmarks
- Increasing our Learning and Development budget significantly to enhance and emphasize our audit methodology, introducing new guidance and reinforcing the importance of professional skepticism and objectivity

Meeting the challenges that must be addressed to consistently perform high-quality audits is our top priority. We look forward to continuing our dialogue with the PCAOB in support of our priority commitment to audit quality. In this regard, we hope that some of the Board's important standard-setting activities — such as proposed standards with regard to auditing fair value measurements, auditing management's estimates, and strengthening firms' systems of quality control — can be accelerated. In our view, the consistency of audit execution, not only within a single firm but across the profession, can be greatly enhanced with standards that reflect the increasingly complex accounting and auditing environment in which we operate.

We would be pleased to discuss any aspect of our response or any further questions you may have.

Sincerely,

A handwritten signature in black ink, appearing to read "Bob Moritz".

Bob Moritz  
US Chairman and Senior Partner  
PricewaterhouseCoopers LLP

A handwritten signature in black ink, appearing to read "Tim Ryan".

Tim Ryan  
US Assurance Leader  
PricewaterhouseCoopers LLP