1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8433
www.pcaobus.org

Report on

2014 Inspection of BDO USA, LLP
(Headquartered in Chicago, Illinois)

Issued by the

Public Company Accounting Oversight Board

December 21, 2015

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

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

PCAOB RELEASE NO. 104-2016-028

2014 INSPECTION OF BDO USA, LLP

Preface

In 2014, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm BDO USA, LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.D of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included reviews of portions of selected issuer audits. These reviews were intended to identify whether deficiencies existed in the reviewed work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report, portions of Appendix B, and Appendix C. Appendix B consists of the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the Firm's system of quality control, those discussions also could eventually be made public, but only to the extent the Firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report. Appendix C presents the text of the paragraphs of the auditing standards that are referenced in Part I.A in relation to the description of auditing deficiencies there.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures[1] for the inspection from August 2014 to February 2015. The inspection team performed field work at the Firm's National Office and at 15 of its approximately 34 U.S. practice offices.

A. Review of Audit Engagements

The inspection procedures included reviews of portions of 22 issuer audits performed by the Firm and a review of the Firm's audit work on one other issuer audit engagement in which the Firm played a role but was not the principal auditor. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix C to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in the references to the auditing standards in this sub-Part, unless the lack of compliance with these standards

[1] For this purpose, the time span for "primary procedures" includes field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. The time span does not include (1) inspection planning, which may commence months before the primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which generally extend beyond the primary procedures.

is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

Certain of the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework and/or its opinion about whether the issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR.

The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.[2]

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[2] Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Depending upon the circumstances, compliance with PCAOB 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 its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure by a firm to take appropriate actions, or a firm's misrepresentations in responding to an

The audit deficiencies that reached this level of significance are described in Part I.A.1 through I.A.17, below.

Effects on Audit Opinions

Of the 17 issuer audits that appear in Part I.A, deficiencies in 15 audits relate to testing controls for purposes of the ICFR opinion, and deficiencies in 17 audits relate to the substantive testing performed for purposes of the opinion on the financial statements, as noted in the table below. Of the 17 audits in which substantive testing deficiencies were identified, 5 audits included deficiencies in substantive testing that the inspection team determined were caused by a reliance on controls that was too high in light of deficiencies in the testing of controls.

	Number of Audits
Deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	15
Deficiencies included in Part I.A related to the financial statement audit only	2
Total	17

Most Frequently Identified Audit Deficiencies

The following table lists, in summary form, the types of deficiencies that are included most frequently in Part I.A of this report. A general description of each type is provided in the table; the description of each deficiency in Part I.A contains more specific information about the individual deficiency. The table includes only the four most frequently identified deficiencies that are in Part I.A of this report and is not a summary of all deficiencies in Part I.A.

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inspection report about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

Issue	Part I.A Audits
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	14 Audits: Issuers A, B, C, D, E, F, G, H, I, J, K, L, N, and O
Failure to test controls over or test the accuracy and completeness of issuer-produced data or reports.	13 Audits: Issuers A, B, C, E, F, G, H, I, J, K, L, N, and O
Failure to perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	10 Audits: Issuers A, D, E, F, G, K, L, M, O, and P
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	9 Audits: Issuers B, C, E, F, H, I, J, K, and P

Audit Deficiencies

A.1. Issuer A

The Firm was engaged by the principal auditor of the issuer to audit the financial statements and ICFR of a subsidiary of the issuer to support the principal auditor's opinions on the consolidated financial statements and ICFR of the issuer. The Firm failed in the following respects to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit –

- The Firm identified certain control deficiencies that existed at the subsidiary's corporate location and a number of its plants. The Firm identified two financial reporting controls that it believed would compensate for these deficiencies. These compensating controls consisted of (1) a review of the financial statements by the subsidiary's controller and chief executive officer, as well as the issuer's chief financial officer ("CFO"), and (2) for only one of the subsidiary's plants, a review of the general ledger by the plant controller. The Firm's procedures to test these compensating controls were limited to inquiring of management and inspecting emails and signatures as evidence that reviews had occurred. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed or (2) ascertaining and evaluating the criteria used by the control owners to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements that could result from the control deficiencies. In addition, the Firm failed to evaluate whether the operating effectiveness of these compensating controls was affected by a significant deficiency that the Firm had identified related to a lack of sufficient management review of the financial statements. (AS No. 5, paragraph 68)

- The Firm failed to perform sufficient procedures to test controls over inventory. Specifically –

    - The Firm failed to identify and test any controls over the timing of the recording of inventory shipments. (AS No. 5, paragraph 39)

    - The Firm's procedures to test certain controls that it selected, consisting of reviews of inventory calculations and analyses, were limited to inquiring of management, inspecting signatures as evidence that reviews had occurred, and, for one of these controls, comparing amounts within the calculations for internal consistency. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed or (2) ascertaining and evaluating the criteria used by the control owners to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of one of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient procedures to test controls over revenue and accounts receivable. Specifically –

- The Firm failed to identify and test any controls over the recognition of routine revenue transactions; the adequacy of the allowances for doubtful accounts, claims, and rebates; and the factoring of the issuer's accounts receivable. (AS No. 5, paragraph 39)

- The Firm selected for testing a control that consisted of a review of manual journal entries for certain non-routine revenue transactions. The Firm failed to sufficiently test this control, as its procedures were limited to inspecting signatures as evidence that a review had occurred. In addition, the Firm tested this control as of six months before the year end but failed to perform any procedures to update the results of its testing to year end. (AS No. 5, paragraphs 42, 44, 55, and 56)

- The Firm failed to identify and test any controls over the accuracy and completeness of the data and reports used in the performance of the control described above and certain other controls over revenue and accounts receivable that the Firm tested. (AS No. 5, paragraph 39)

• The Firm identified a fraud risk related to the occurrence of revenue due to the significance of the account and the potential for management override of controls. In addition, during its substantive procedures, the Firm identified numerous misstatements related to both revenue and accounts receivable. Further, the subsidiary's management informed the Firm that a bill-and-hold sale had been recorded without appropriate supporting documentation. The Firm, however, failed to evaluate whether, in light of these circumstances, it needed to modify (1) its assessment of the risk of material misstatement for the other assertions related to revenue and for accounts receivable and (2) the nature, timing, and extent of its substantive procedures related to revenue and accounts receivable. (AS No. 13, paragraph 46; AS No. 14, paragraphs 14 and 19) In addition, the Firm's substantive procedures to test revenue were insufficient in the following respects –

  - The Firm failed to test any journal entries related to revenue, or perform any other procedures, to address the risk of management override of the controls related to revenue. (AU 316, paragraph .61)

- The Firm's sample size to test revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AU 350, paragraphs .16, .18, .18A, and .23)

- The Firm failed to perform any procedures to test sales rebates recorded in the first nine months of the year and sales discounts recorded during the year; the total amount of these rebates and discounts was multiple times the established level of materiality for the subsidiary. (AS No. 13, paragraph 8)

- The Firm failed to perform sufficient substantive procedures to test inventory. Specifically –

  - The Firm failed to test the existence of certain inventories. (AS No. 13, paragraph 8)

  - For certain other inventories, the Firm identified differences between its test counts and management's counts. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasons for these differences, nor did the Firm expand its test counts or perform any alternative procedures to obtain sufficient evidence that the recorded inventory quantities were accurate. (AU 331, paragraph .09)

  - The Firm failed to sufficiently test certain inventories located at external facilities, for which requested confirmations were not returned by the external facilities. Specifically, for those inventories, the Firm either (1) limited its procedures to comparing the balance in the current year to the prior-year balance or (2) performed no procedures. (AU 330, paragraphs .31 and .33; AU 331, paragraph .14)

A.2. Issuer B

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

- The Firm failed to perform sufficient procedures to test controls over inventory. The Firm selected for testing controls that consisted of reviews of inventory variances and the inventory allowance. The Firm's procedures to test these controls were limited to inquiring of management, obtaining certain documents that were reviewed during the operation of the controls, and inspecting signatures as evidence that reviews had occurred. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed or (2) ascertaining and evaluating the criteria used by the control owners to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain data and reports used in the performance of these controls, and also in a control over adjustments to inventory quantities that the Firm tested. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test the existence of inventory. The issuer performed a physical count of all inventory at an interim date more than four months before year end. The issuer also performed a physical count of all raw materials and work-in-process inventory after year end; the Firm's planned procedure to test the existence of this inventory was to roll back these inventory balances from the date of the subsequent count to year end. The Firm's roll-back procedures were insufficient, as the Firm limited its procedures to comparing a very small sample of items counted to the quantities at year end. In addition, the Firm failed to perform any procedures to roll forward the finished goods inventory balance from the date of the interim count to year end. (AS No. 13, paragraph 45; AU 331, paragraph .12)

- The Firm failed to perform sufficient substantive procedures to test the accuracy and completeness of certain data and evaluate the reasonableness of certain significant assumptions that the issuer used to develop the inventory allowance. Specifically, the Firm failed to test the accuracy and completeness of the allocation of inventory items to certain of the various classes of inventory that were used in calculating the inventory allowance. In addition, the Firm failed to sufficiently evaluate the reasonableness of certain reserve percentages and manual adjustments that management used to determine the allowance for certain of these classes of inventory. Specifically, although the Firm traced a sample of items in the allowance to the inventory sub-ledger to test whether any additional allowance was necessary, the Firm performed only inquiry to conclude on the amounts reserved for these items. (AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures to test controls over pension assets and liabilities. Specifically –

  - The issuer engaged a service organization to provide various services with respect to the issuer's pension assets, including valuing those assets. In evaluating the issuer's controls over the valuation of the pension assets, the Firm failed to determine whether the issuer had a sufficient understanding of how those assets were valued (including the specific methods and assumptions used by the service organization) to enable the issuer to determine whether (1) the valuations were reasonable and determined in accordance with generally accepted accounting principles ("GAAP"), and (2) the securities were appropriately classified within the fair value hierarchy set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurement*. In addition, although the Firm obtained a service auditor's report for the service organization that addressed controls over the processing of benefit plan payments, the Firm failed to identify and test any controls over the other services provided by the service organization; the issuer relied on the controls over these services, which consisted of custodial, investment management, accounting, and reporting services. (AS No. 5, paragraph 39)

- The Firm selected for testing a control that consisted of a review of the recorded values of the pension assets and liabilities, as well as a review of certain significant assumptions underlying these values. The Firm's procedures to test this control were limited to inspecting signatures as evidence that a review had occurred, comparing amounts from the issuer's external actuary's report to the service organization's report and the issuer's disclosures, and reading the issuer's memorandum regarding the key assumptions used in the actuary's calculation of the fair value of the pension assets. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed or (2) ascertaining and evaluating the criteria used by the control owners to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to identify and test any controls over the accuracy and completeness of the data that the issuer provided to the service organization for use in the calculation of the pension liability. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test the valuation and presentation of pension assets. Specifically –

  - The pension assets consisted of investment securities that held a variety of underlying investments. The Firm's procedures to test the values of these investment securities consisted of using its internal specialist to obtain prices for certain of the underlying investments held by the investment securities. The Firm, however, failed to test how the fair values of the investment securities were developed based on the fair values of these underlying investments. (AU 328, paragraph .03)

  - The Firm failed to test whether the issuer's classification of the pension assets within the fair value hierarchy was in compliance with FASB ASC Topic 820. (AU 328, paragraph .43)

A.3. Issuer C

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

- The Firm established a materiality level for certain balance sheet accounts, including loans receivable and investments, that was approximately twenty times larger than its materiality level for the other accounts, including income statement accounts. The testing of the loans receivable and investment accounts was insufficient because the resulting sample sizes and thresholds used to select items for testing of those accounts were not designed to provide the necessary level of assurance of detecting misstatements in those accounts that could also materially affect net income. (AS No. 11, paragraph 6)

- The Firm failed to perform sufficient procedures related to the allowance for loan losses ("ALL"), as follows –

  - The Firm selected for testing a control that consisted of a review of the ALL.

    - The Firm's procedures to test this control were limited to inquiring of management, reading the documentation of the ALL calculation and the meeting minutes of the ALL committee, comparing certain balances in the meeting minutes to those in the ALL analysis, obtaining a management report used during part of the review, and testing the control's verification of the mathematical accuracy of certain calculations. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed to evaluate the reasonableness of the ALL or (2) ascertaining and evaluating the criteria used by the control owner to identify matters for investigation and whether such matters were appropriately investigated and resolved. As a result, the Firm failed to test whether this control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to evaluate whether this control addressed an important aspect of the process related to the identification of impaired loans and the determination of the amount reserved for each of these loans, or identify and test another control that addressed this risk. (AS No. 5, paragraph 42)

o The Firm failed to identify and test any controls over the accuracy and completeness of certain data used in the performance of the control discussed above and another control over the ALL that the Firm tested. (AS No. 5, paragraph 39)

o The issuer and the Firm concluded that there was a deficiency in a control over troubled debt restructurings, but the Firm failed to sufficiently evaluate the severity of the deficiency. Specifically, the Firm identified the control discussed above, which consisted of the review of the ALL, as a control that would compensate for this deficiency. The Firm's testing of this control was deficient as discussed above, and the Firm failed to evaluate whether the compensating control mitigated the risks related to the deficiency in the control over troubled debt restructurings. (AS No. 5, paragraph 68)

o The Firm failed to perform sufficient substantive procedures to test the general component of the ALL, as the Firm failed to sufficiently evaluate the reasonableness of certain significant assumptions used in the calculation of this component. Specifically, the Firm's procedures were limited to inquiring of management; reading the meeting minutes of the ALL committee; testing the mathematical accuracy of certain of the calculations underlying one of the assumptions; comparing certain amounts used in the calculation of the general component to supporting documents or the general ledger; and evaluating, based on the Firm's knowledge of the industry and the issuer, trends in the ALL balance and certain metrics related to the ALL. (AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures related to the valuation of investment securities. Specifically –

  - The issuer recorded the fair values of investment securities based on the prices received from an external pricing service and then compared the recorded fair values to prices received from another external pricing service. The Firm selected for testing a control that consisted of the preparation and review of the comparison. The Firm's procedures to test this control were limited to inquiring of management, reading a memorandum prepared as part of the control, and inspecting signatures as evidence that a review had occurred. The Firm's testing did not include ascertaining and evaluating the criteria used by the control owner to identify matters for investigation and whether such matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of a report used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

  - As described in the first paragraph regarding this audit, the Firm used a sample to test the investment securities that was designed using an inappropriate level of materiality. In addition, the Firm determined the sample based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. For both of these reasons, the sample that the Firm used to test investment securities was too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.4. Issuer D

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

- The Firm failed to perform sufficient procedures to test controls over revenue and accounts receivable. Specifically –

    - The Firm failed to sufficiently test controls over the accuracy of the pricing in the sales orders that were used to generate invoices. The Firm identified and tested controls that consisted of (1) a review of the allowance for sales returns, discounts, and credit memoranda and (2) a review of the financial statements. The Firm, however, failed to test whether the first of these controls would timely prevent or detect material misstatements and whether the second of these controls operated at a level of precision that would prevent or detect material misstatements related to the pricing of sales orders. (AS No. 5, paragraphs 42 and 44)

    - The Firm selected for testing two automated controls in the system used to process revenue and accounts receivable transactions. The Firm, however, failed to perform sufficient procedures to test these controls, as the Firm limited its procedures for each control to testing two transactions that were processed by the system, without testing either the parameters that were set up in the system related to the controls or whether these controls prevented the processing of transactions that did not meet the relevant parameters. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform sufficient procedures related to inventory. Specifically –

    - The issuer's inventory was subject to monthly cycle counts. The Firm's procedures to test the existence of, and controls over the existence of, this inventory were insufficient. Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency. (AS No. 5, paragraph 39; AU 331, paragraph .11)

    - The Firm selected for testing an automated control that consisted of a three-way match among the purchase order, receiving document, and vendor invoice; both quantities and prices were subject to the match. The Firm's procedures to test this control were insufficient, as the Firm limited its procedures to inquiring of issuer personnel and testing the control's operation for two vendor payments, without testing either the set-up of this control within the system or whether this control prevented the processing of transactions that did not match. (AS No. 5, paragraphs 42 and 44)

- The Firm designed certain of its substantive procedures – including sample sizes – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, certain of the samples that the Firm used to test revenue, accounts receivable, and the valuation of inventory were too small to provide sufficient evidence. In addition, the Firm's sample size to test revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .16, .18, .18A, .19, .23, and .23A)

A.5. Issuer E

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

- The Firm failed to perform sufficient procedures related to revenue from contracts accounted for using either the proportional performance method or the percentage-of-completion ("POC") method.

    - o The Firm selected for testing a control that consisted of a review of the estimated completion percentage for all open projects. The Firm's procedures to test this control were limited to inquiring of members of the issuer's accounting staff, who were not the control owners, and obtaining the schedule of open projects to inspect the signatures as evidence that the review had occurred. The Firm's testing did not include ascertaining and evaluating the review procedures that the control owners performed. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to sufficiently test the estimated costs to complete the contracts, as the Firm's testing was limited to (1) for certain open contracts, comparing the issuer's estimated costs to complete to the estimated costs to complete in an issuer-provided schedule and (2) for a small number of completed contracts, comparing the effective rate earned per hour to the issuer's established rate and noting that one of the contracts showed a difference that indicated a risk related to management's ability to estimate. (AS No. 13, paragraph 8; AU 342, paragraph .07)

- The issuer's largest subsidiary entered into contracts involving multiple elements, and the Firm identified a fraud risk related to revenue recognition from such contracts. The Firm, however, failed to perform sufficient procedures related to revenue for this subsidiary, as follows –

  - The Firm selected for testing a control that consisted of the review of a memorandum and supporting analyses summarizing management's evaluation of vendor-specific objective evidence ("VSOE") of the fair value of certain significant elements. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraph 39)

  - The Firm's substantive procedures to test VSOE were limited to comparing certain data in the issuer's analyses to contracts, verifying that certain sales were appropriately included in the analyses, and testing the mathematical accuracy of the analyses. The Firm, however, failed to test the determination of the median prices for the elements; these median prices were key inputs to the analyses of VSOE. (AS No. 13, paragraph 8)

  - To test the revenue transactions, the Firm selected all contracts that exceeded a threshold. To test the remaining contracts, which represented 92 percent of the subsidiary's revenue, the Firm selected a sample of contracts. This sample was too small to provide sufficient evidence, given the significant risks related to this revenue and the size of the balance related to the remaining contracts. (AS No. 13, paragraphs 8 and 42; AU 350, paragraphs .23 and .23A)

A.6. Issuer F

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 on the effectiveness of ICFR –

- The Firm failed to perform sufficient procedures to test controls over revenue and deferred revenue, the allowance for excess and obsolete inventory, the valuation of deferred tax assets, and the valuation of goodwill. The Firm selected for testing controls that consisted of (1) reviews, approvals, or reconciliations of revenue and deferred revenue, the allowance for excess and obsolete inventory, and the valuation of deferred tax assets and (2) the preparation of an analysis of the potential impairment of goodwill and a review of that analysis. The Firm's procedures to test these controls were limited to inquiring of management, inspecting signatures or other notations as evidence that reviews had occurred, and, for two of the controls over revenue, comparing certain amounts to an underlying analysis prepared by the issuer and reviewing reports used in the controls for accuracy. In addition, in its evaluation of the control over the valuation of goodwill, the Firm considered the results of certain of its substantive procedures related to the goodwill impairment analysis. The Firm's testing of these controls did not include (1) ascertaining the nature of the review procedures that the control owners performed or (2) ascertaining and evaluating the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately addressed. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of data used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, 44, and B9)

- The Firm failed to perform sufficient procedures to test controls over the accounting for business combinations. Specifically –

  - The Firm selected for testing a control that consisted of management's review of additions to intangible assets. The Firm's procedures to test this control were limited to inquiring of management and inspecting signatures as evidence that an analysis of the additions had been prepared and reviewed. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owner performed or (2) ascertaining and evaluating the criteria used by the control owner to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. Further, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

  - The Firm also considered certain controls that operated at the financial statement level to address the risk of material misstatement related to the accounting for business combinations. These controls included the board of directors' review of operating results and significant transactions, management's review of the quarterly financial reports, and the preparation and review of balance sheet account reconciliations. The Firm, however, failed to test whether any of these controls was designed to operate at a level of precision that would prevent or detect material misstatements related to the accounting for business combinations. (AS No. 5, paragraph 42)

- The Firm failed to perform sufficient substantive procedures to test the issuer's annual analysis of the potential impairment of goodwill for one reporting unit. The discounted cash-flow forecast that the issuer used in estimating the fair value of this reporting unit included substantial revenue and associated costs related to the issuer's introduction of a new product. The Firm failed to sufficiently evaluate the reasonableness of the significant assumptions underlying the forecasts related to the new product (including the projected growth in sales, changes in gross margins, and projected market share), as its procedures were limited to (1) reading the issuer's analysis, (2) inquiring of management, and (3) reading the issuer's specialist's analysis of the potential market for the new product. In addition, the Firm compared the issuer's forecasts for the past two years with the results for those periods; this comparison showed significant variances between actual and forecasted amounts, but the Firm failed to consider whether these results should have had an effect on its consideration of the reliability of the forecast. Further, while the forecast suggested that the assumptions underlying the cash-flow forecasts used to analyze the potential impairment were different from the assumptions underlying the forecasts of taxable income used in the issuer's valuation of deferred tax assets, the Firm failed to consider these apparent differences when concluding on the reasonableness of the assumptions. (AS No. 14, paragraph 3; AU 328, paragraphs .26, .28, and .36)

- The Firm failed to perform sufficient substantive procedures to test the issuer's valuation of deferred tax assets, as it failed to sufficiently evaluate the forecast of taxable income that the issuer used in its valuation of deferred tax assets. Specifically, the Firm failed to evaluate the reasonableness of the issuer's estimates of taxable income included in the forecast, beyond considering them in light of the issuer's results for the prior three years. In addition, as discussed above, the Firm failed to evaluate the implications of significant differences between the issuer's actual results compared to its previous forecasts, beyond noting that the issuer's industry was cyclical. The Firm also failed to consider the apparent differences between the assumptions used in this analysis and the analysis of the potential impairment of goodwill, also as discussed above. (AS No. 14, paragraph 3; AU 342, paragraph .11)

- The Firm's sample size to test revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AU 350, paragraphs .16, .18, .18A, and .23)

A.7. Issuer G

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

- The Firm failed to perform sufficient procedures related to revenue and accounts receivable for two of the issuer's components, which accounted for over 90 percent of the issuer's revenue. Specifically –

    - For both components, the Firm's planned approach included testing certain (1) controls over access to particular functions and (2) controls involving segregation of specific incompatible duties within the systems used to process revenue and accounts receivable transactions, but it failed to sufficiently test these controls. Specifically, the Firm relied on its testing of controls over the granting of user access to the systems overall to conclude on the effectiveness of these controls; however, it failed to determine whether these controls over the granting of user access were effective in preventing inappropriate access to the particular functions and segregating the incompatible duties, as the selected controls were purported to do. (AS No. 5, paragraphs 42 and 44)

    - The Firm selected for testing automated controls in the systems used to process revenue and accounts receivable transactions. For one of the two components, the Firm failed to perform sufficient procedures to test certain of these controls, as the Firm limited its procedures for each control to testing one transaction that was processed by the systems, without testing either the parameters that were set up in the system related to these controls or whether the controls appropriately processed the various types of transactions based on the relevant system parameters. (AS No. 5, paragraphs 42 and 44)

    - For each component, the Firm selected for testing a control that consisted of the comparison of revenue to the component's budget and to prior-period results or to various sales-related metrics. The Firm's procedures to test these controls were limited to inquiring of management and inspecting emails and other documentation prepared as part of the controls. The Firm failed to (1) ascertain the nature of the procedures performed as part of the review and (2) ascertain and evaluate the criteria used by the reviewers to identify matters for investigation and whether those matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- For one of the components, the Firm designed its substantive procedures to test revenue and accounts receivable based on reliance on controls; the level of control reliance that the Firm used to design certain of its substantive procedures – including sample sizes – was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, certain of the samples that the Firm used to test revenue and accounts receivable were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

- For the other component, the Firm failed to perform sufficient substantive procedures to test revenue. In designing and executing its procedures to test revenue, the Firm determined that there was not a fraud risk related to improper revenue recognition, based in part on an inappropriate and unsupported assessment that computer systems were designed properly and controls were in place to prevent fraud related to improper revenue recognition. The Firm failed to reassess that determination despite the following factors:

  - During the year, the Firm became aware of certain allegations of fraud.
  - The Firm identified a control deficiency related to the fact that certain accounting personnel had administrator-level

access to the component's revenue application during the majority of the year.

- The Firm's testing of the control that consisted of the comparison of revenue to budget and prior periods was insufficient as discussed above.

(AS No. 12, paragraph 65; AS No. 13, paragraph 46)

- The issuer acquired various businesses during the year and accounted for these acquisitions as business combinations. The Firm selected for testing controls that consisted of the determination and review of the accounting for business combinations, including the valuation of the assets acquired and liabilities assumed. The Firm's procedures to test these controls were limited to evaluating the qualifications of the control owners, inquiring of management, and inspecting emails as evidence that reviews had occurred. The Firm failed to (1) ascertain the nature of the procedures performed by the control owners and (2) ascertain and evaluate the criteria used by the control owners to identify matters for follow up and whether those matters were appropriately addressed. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient procedures to test controls over inventory. For one of the two components discussed above, the Firm identified deficiencies in controls over inventory, and it identified two controls that it believed compensated for these deficiencies. The controls consisted of reviews of the financial statements at the component level by the issuer's and component's management. The Firm failed to sufficiently test these compensating controls, as it failed to (1) ascertain the nature of the procedures performed by the control owners and (2) ascertain and evaluate the criteria used by the reviewers to identify matters for follow up and whether those matters were appropriately addressed. In addition, the Firm failed to test any controls over the accuracy and completeness of the data used in the performance of the controls. (AS No. 5, paragraphs 39 and 68)

A.8. Issuer H

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

- The Firm established a materiality level for certain balance sheet accounts, including investment securities, loans receivable, and assets acquired and liabilities assumed in a business combination, that was more than thirty times larger than its materiality level for the other accounts, including income statement accounts. The testing of the accounts for investment securities, loans receivable, and assets acquired and liabilities assumed in a business combination was insufficient because the resulting sample sizes and thresholds used to select items for testing of those accounts were not designed to provide the necessary level of assurance of detecting misstatements in those accounts that could also materially affect net income. (AS No. 11, paragraph 6)

- The Firm failed to perform sufficient procedures to test controls over loans receivable and the ALL, as follows –

  - The Firm selected for testing a control that consisted of a review of the ALL by the CFO. The Firm's procedures to test this control were limited to inquiring of the CFO, noting signatures on the calculation as evidence that the review had occurred, and gaining an understanding of the formulae used in certain of the spreadsheets underlying the calculation of the ALL. The Firm failed to (1) ascertain the nature of the review procedures that the CFO performed and (2) ascertain and evaluate the specific criteria used by the CFO to identify matters for investigation and whether such matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

  - In the third quarter of the year, the issuer began using a service organization to process loan transactions. The Firm, however, failed to obtain sufficient evidence related to the design and operating effectiveness of controls over the processing of loan transactions by the service organization. The Firm obtained the service auditor's report, which covered the first three months of the year, and a letter from the service organization stating that there were no changes to the service organization's controls for the next three months of the year. The Firm failed to obtain evidence about the effectiveness of the controls for the period of reliance not covered by the service auditor's report. (AS No. 5, paragraph B19)

- The Firm identified certain control deficiencies related to user access to the system for processing loans and deposits, as well as to the general ledger system. These deficiencies consisted of (1) certain management personnel in operations and accounting having administrator access to these systems and (2) all users with access to the system for processing loans and deposits having the ability to initiate and modify data within that system. In addition, the Firm identified a fraud risk related to the user-access deficiencies in the system for processing loans and deposits. The Firm identified and tested compensating controls - which comprised certain transaction-level controls over loans receivable and the ALL, as well as the control described above that consisted of the review of the ALL by the CFO - that it believed mitigated the effect of these user-access control deficiencies, but it failed to obtain sufficient evidence to support its conclusion that the compensating controls operated at a level of precision that would prevent or detect material misstatements resulting from these deficiencies. Specifically, in addition to the deficiency in the testing of the ALL control that is described above –

  - The Firm failed to evaluate the effect of a lack of risk ratings for certain loans receivable within the ALL calculation on its conclusions about the operating effectiveness of certain of these compensating controls. (AS No. 5, paragraph B8)

  - The Firm tested the operating effectiveness of one of these compensating controls through the second quarter, but failed to perform any procedures to update the results of its testing from that interim date to the issuer's year end. (AS No. 5, paragraphs 55 and 56)

- o The Firm failed to identify and test any controls over the accuracy and completeness of data, derived from the applications with user-access deficiencies, that the issuer used in the performance of certain of the compensating controls, including the ALL control described above. (AS No. 5, paragraph 39)

- As described in the first paragraph regarding this audit, the Firm used a sample to test loans receivable that was designed using an inappropriate level of materiality. In addition, the Firm determined the sample based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of the controls that are discussed above. For both of these reasons, the sample that the Firm used to test loans receivable was too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically, the Firm's procedures to evaluate the qualitative factors used in the calculation of the general component of the ALL were limited to reading the issuer's memorandum documenting its consideration of those factors and comparing the factors to those for the prior year; the Firm inquired of management as to the reasons for changes in these factors, but obtained corroboration of the reasons provided for the changes in only two of the nine factors that had changed. In addition, the Firm failed to test the loan risk ratings, which were used as a significant input to the calculation of the general component of the ALL. (AU 342, paragraph .11)

A.9. <u>Issuer I</u>

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

- The Firm established a materiality level for certain balance sheet accounts, including loans receivable, the specific component of the ALL, and investment securities, that was approximately twenty times larger than its materiality level for the other accounts, including income statement accounts. The testing of the loans receivable and investment securities accounts, as well as the specific component of the ALL, was insufficient because the resulting sample sizes and thresholds used to select items for testing of those accounts were not designed to provide the necessary level of assurance of detecting misstatements in those accounts that could also materially affect net income. (AS No. 11, paragraph 6)

- The Firm failed to perform sufficient procedures to test controls over the valuation of loans and the ALL, as follows –

    - The Firm selected for testing a control that consisted of the review of the ALL and the associated loans by the ALL committee and the board of directors. The Firm failed to sufficiently test this control in the following respects –

        - The Firm's procedures to test this control were limited to inquiring of management, obtaining the ALL calculation, reading the minutes for one ALL committee meeting, and reading various memoranda prepared to summarize the conclusions reached by the committee. The Firm also referenced certain substantive procedures that it performed related to the ALL calculation when addressing its evaluation of this control. The Firm failed, however, through any of its procedures, to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements related to the ALL. Specifically –

            - The Firm failed (1) to ascertain the nature of the review procedures that the control owners performed and (2) to ascertain and evaluate the specific criteria used by the control owners to identify matters for investigation and whether such matters were appropriately investigated and resolved. (AS No. 5, paragraphs 42, 44, and B9)

- The Firm failed to test important aspects of the control related to the review of (1) the calculation of historical charge-off factors and (2) the reasonableness of certain assumptions used to calculate the general component of the ALL, including the qualitative factors that were used. (AS No. 5, paragraph 42)

- The Firm failed to evaluate whether this control addressed important aspects of the process related to the identification of impaired loans and the determination of the amount reserved for each of these loans, or identify and test another control that addressed these aspects. (AS No. 5, paragraph 42)

- The Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraph 39)

o The Firm failed to perform sufficient procedures to test controls over the periodic valuation of loans previously acquired with credit deterioration. Specifically –

▪ The Firm selected for testing a control that addressed the accuracy of the data used in the periodic valuation of loans previously acquired with credit deterioration. The Firm tested this control in the first quarter of the year but did not perform any procedures to determine whether this control operated effectively at year end. (AS No. 5, paragraphs 55 and 56)

▪ The Firm failed to identify and test any controls that addressed the reasonableness of the significant assumptions that were used in the periodic valuation of loans previously acquired with credit deterioration. (AS No. 5, paragraph 39)

- o The Firm failed to identify and test any controls over the completeness of the reports used in the performance of a control that the Firm selected for testing, which consisted of the review of troubled debt restructurings. (AS No. 5, paragraph 39)

- o The Firm failed to sufficiently test controls over other real estate owned ("OREO"). Specifically, the Firm stated that it used the work performed by the issuer's internal audit ("IA") department as evidence of the effectiveness of two controls that addressed the recording of activity in, and the reconciliation of, the OREO account, but the Firm failed to test IA's work. In addition, the Firm selected for testing a control that consisted of management's review of the activity and balances for all monthly general ledger accounts, and the Firm referenced this control as addressing the risks related to OREO. The Firm, however, failed to obtain evidence that this control operated at a level of precision that would prevent or detect material misstatements related to OREO. (AS No. 5, paragraphs 19, 42, and 44; AU 322, paragraphs .20, .21, and .26)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically –

  The Firm failed to sufficiently evaluate the reasonableness of certain assumptions used to calculate the general component of the ALL. The Firm's procedures were limited to inquiring of management, reading the minutes of the ALL committee meeting, testing the mathematical accuracy of certain calculations, comparing loan balances to the subsidiary ledger and/or other supporting documentation, evaluating the consistency of changes in qualitative factors with its expectations based on the Firm's knowledge of trends for the issuer and the industry, and performing a retrospective review of the total consolidated ALL. These procedures were not sufficient to evaluate the reasonableness of the historical loss experience factor or the qualitative factors used in the calculation of the general component, as they either did not address these specific assumptions or were limited to assessing only the direction of any changes. (AU 342, paragraph .11)

- o The Firm failed to sufficiently evaluate the reasonableness of certain significant assumptions that the issuer used in the periodic valuation of certain loans previously acquired with credit deterioration, as the Firm's procedures were limited to (1) reading a management report and concluding that the rationale for the significant inputs and assumptions used appeared reasonable, without obtaining evidence to support this conclusion, and (2) recalculating certain charge-off rates, comparing them to the amounts used by the issuer, and noting certain significant differences; the Firm, however, relying on an unsupported presumption that they would not have a material effect on the valuation, did not evaluate these differences. (AU 342, paragraph .11)

A.10. Issuer J

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

- The Firm established a materiality level for certain balance sheet accounts, including loans receivable, that was approximately twenty times larger than its materiality level for the other accounts, including income statement accounts. The testing of the loans receivable account was insufficient because the resulting sample size for testing this account was not designed to provide the necessary level of assurance of detecting misstatements in this account that could also materially affect net income. (AS No. 11, paragraph 6)

- The Firm failed to perform sufficient procedures to test controls over the ALL. The Firm selected for testing controls that consisted of (1) the controller's review of the ALL calculation prepared by the CFO and (2) the board of directors' periodic approval of additions to the ALL. The Firm's procedures to test these controls were limited to inquiring of management, obtaining documents with signatures that indicated a review had occurred, and attending a meeting of the board of directors to observe the approval of the ALL. The Firm, however, failed to ascertain the nature of the review procedures performed, including the criteria that the control owners used to identify matters for follow up and whether those matters were appropriately resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to evaluate whether, in light of the fact that the controller reported to the CFO, the controller had the necessary authority to perform a review of the CFO's ALL calculation. Further, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically, the Firm failed to sufficiently test the qualitative factors that the issuer used in the calculation of the ALL, as the Firm's procedures were limited to comparing the qualitative factors to those used in the prior year, inquiring of management regarding the reasons for the changes, and reading the issuer's ALL memorandum, which did not provide a detailed evaluation of these factors. (AU 342, paragraph .11)

A.11. <u>Issuer K</u>

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

- The Firm failed to perform sufficient procedures to test controls over certain reserves for employee-related and warranty costs and over the allowance for excess and obsolete inventory. The Firm selected for testing controls that consisted of management's review of analyses, calculations, reconciliations, or reports. The Firm's procedures to test these controls were limited to inquiring of management, inspecting documents with signatures that indicated reviews had occurred, testing the mathematical accuracy of certain calculations, tracing certain amounts to the general ledger or supporting documentation, and obtaining journal entries resulting from the review. The Firm, however, failed to ascertain and evaluate the nature of the review procedures performed, including the criteria that the control owners used to identify matters for follow up and whether those matters were appropriately resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of data and reports used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient procedures to test controls over inventory costs. During the year, the issuer implemented a new enterprise resource planning application, which included processes to classify and allocate inventory costs; the Firm tested the implementation of the new application by reading the implementation plan and inquiring of management. The Firm selected for testing a control over inventory costs that consisted of the monthly calculation and review of manufacturing variances. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the data that the issuer used in the performance of this control, which were derived from the enterprise resource planning application. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test the allowance for excess and obsolete inventory. To test the inventory usage data, which constituted a significant input to the estimation of the allowance, the Firm selected a sample of products and, for each product, obtained a usage report that was generated by the inventory system. For usage reports for unfinished products, however, the Firm's testing was limited to selecting one item from each report and comparing that item to another report from the same inventory system, which it had not tested. The Firm also failed to sufficiently evaluate the reasonableness of the adjustments that management made to the reserve to exclude certain items based on expected future use, as the Firm's procedures were limited to comparing the adjustments to those made in prior periods and inquiring of management, without obtaining corroboration of the explanations for differences. (AU 342, paragraph .11)

- The Firm's sample size to test revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AU 350, paragraphs .16, .18, .18A, and .23)

A.12. 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 on the effectiveness of ICFR –

- The Firm failed to perform sufficient procedures related to revenue and certain accounts receivable. Specifically –
  - For one of the issuer's two types of revenue, the Firm failed to identify and test any controls that addressed the accuracy of the prices used to record certain transactions that represented over three quarters of total revenue. (AS No. 5, paragraph 39)
  - For the issuer's other type of revenue, the Firm selected for testing a control that consisted of a comparison of operational results, including this revenue, by location to the budget. The Firm's procedures to test this control were limited to noting that there were explanations for all differences meeting the control owner's threshold for review. The Firm failed to test whether this control addressed whether the relevant criteria for recognition of revenue had been met. In addition, the Firm's testing did not include evaluating how the control owner identified items for follow up and whether these items were appropriately resolved. Further, the Firm failed to identify and test any controls over the development of the budget that was used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)
  - For both types of revenue, the Firm failed to identify and test any controls over the accuracy and completeness of data used in a control over the recording of unbilled revenue that the Firm had selected for testing. (AS No. 5, paragraph 39)
  - The samples that the Firm used to test revenue and certain accounts receivable were too small to provide sufficient evidence. Specifically, the Firm's sample sizes for testing revenue, as well as its sample size for testing the accounts receivable balance related to the first type of revenue, were not designed to appropriately

consider tolerable misstatement for the population. In addition, the Firm determined its sample sizes for the first type of revenue based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .16, .18, .18A, .19, .23, and .23A)

- The Firm failed to perform sufficient procedures to test controls over the valuation of assets acquired and liabilities assumed in a business combination. The Firm selected for testing controls that consisted of the review of the acquisition checklist and supporting documents, the purchase price allocation, and the journal entry made to record the assets acquired and liabilities assumed. The Firm's procedures to test these controls were limited to inquiring of management, reading a memorandum that summarized this business combination, and inspecting signatures as evidence that reviews had occurred. The Firm failed to ascertain and evaluate the nature of the review procedures the control owners performed, including the criteria they used (1) to assess whether the valuations were reasonable and (2) to identify matters for follow up and whether those matters were appropriately resolved. As a result, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

A.13. Issuer M

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 Firm failed to perform sufficient procedures to test the valuation of certain inventory for one of the issuer's significant components; this inventory represented the majority of this component's inventory. Specifically, the Firm's substantive procedures were limited to performing analytical procedures that consisted of calculating a ratio of cost of goods sold to sales for each of the three prior years, comparing these ratios to the same ratio for the first nine months of the current year and investigating fluctuations over a certain threshold. These procedures failed to provide the necessary level of assurance regarding the valuation of inventory. In addition, the Firm failed to establish an appropriate threshold for the investigation of differences that would have allowed the Firm to identify differences that may have been potential material misstatements. (AS No. 13, paragraph 36; AU 329, paragraph .20)

- The Firm failed to perform sufficient procedures to test one type of revenue and accounts receivable for the component noted above and one other component; this revenue represented the majority of the components' revenue. Specifically –

  - The Firm's planned approach for testing this revenue was to use substantive analytical procedures; these procedures consisted of comparisons of certain disaggregated current-year sales to budgeted or prior-year sales. These analytical procedures, however, provided little to no substantive assurance, as the Firm failed to (1) sufficiently test the budgeted sales, in that the Firm limited its procedures to obtaining a general understanding of the budget process and inquiring of management, and (2) establish an appropriate threshold for investigation of differences that would have allowed the Firm to identify differences that may have been potential material misstatements. Certain of the Firm's thresholds exceeded its established level of materiality, and, as a result, the Firm failed to evaluate certain differences that it identified that exceeded that level of materiality. (AU 329, paragraphs .16 and .20)

  - The Firm tested the existence of accounts receivable as of an interim date. The Firm's procedures to extend its conclusion to year end were not sufficient. Specifically, these procedures were limited to (1) comparing sales activity to system-generated reports, (2) comparing the year-end balance to the subsidiary ledger and also to the balance at the date of its interim testing, and (3) comparing certain percentages and ratios, which were based on the balances at the interim date and year end, and noting that the amounts were consistent with prior periods. (AS No. 13, paragraph 45)

A.14. Issuer N

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

- The Firm failed to perform sufficient procedures to test controls over income taxes and the valuation of fixed assets in stores. The Firm selected certain controls that consisted of the review of certain income tax calculations and analyses and the quarterly review of store fixed assets to identify impairments. The Firm's procedures to test these controls were limited to inquiring of management and one or more of the following procedures: inspecting signatures as evidence that reviews had occurred, comparing certain amounts to supporting documents, and reading the documents that were reviewed during the operation of the controls. The Firm's testing did not include ascertaining the nature of the procedures performed by the control owners or evaluating the criteria used by the control owners to identify matters for investigation and whether those matters were appropriately resolved. Therefore, the Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of data used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test retail revenue. To test this revenue, the Firm performed three analytical procedures, but these analytical procedures provided little to no substantive assurance for the following reasons –

    - The first analytical procedure compared actual sales to expected sales. The expected sales were determined by grouping the issuer's stores into two categories and computing actual sales for the prior year for each category; the expectation for one category was then adjusted to reflect certain price decreases. In developing its expectations, the Firm failed to obtain evidence as to why the prior-year sales could be expected to be predictive of the current-year sales. In addition, the Firm evaluated the results of the analytical procedure by combining the two categories of stores, which resulted in the Firm not investigating significant differences between the actual and expected sales for both categories. (AU 329, paragraphs .05, .13, .14, and .19)

- o The second analytical procedure compared sales by season to the prior year's sales by season. The Firm identified certain differences that were in excess of its thresholds for investigation, but the Firm limited its procedures to evaluate these differences to inquiring of management, without obtaining corroboration of management's explanations beyond noting that they were generally consistent with inventory trends. (AU 329, paragraph .21)

- o The final analytical procedure compared sales by store to the sales for the same store in the prior year. The Firm, however, failed to establish an appropriate expectation for the sales by store, as it did not obtain evidence as to why the prior-year sales by store could be expected to be predictive of the current-year sales. In addition, the Firm established a threshold for investigation of unexpected differences that exceeded the average annual sales per store and, as a result, did not provide the necessary level of assurance that differences that could have been potential material misstatements would be identified for investigation. Further, for certain differences that did exceed the Firm's threshold, the Firm failed to obtain corroboration of management's explanations. (AU 329, paragraphs .05, .13, .14, .20, and .21)

A.15. Issuer O

In this audit of a manufacturer and distributor of products for commercial and consumer use, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR –

- The issuer entered into incentive programs with its customers and recorded an accrual for these program costs. The Firm failed to perform sufficient procedures related to accrued sales incentive program costs, as follows –

- o The Firm selected for testing a control that consisted of reviews of the accrual and associated payments. The Firm's procedures to test this control were limited to inquiring of management, reading memoranda prepared by management, and comparing information in the memoranda to the general ledger and supporting schedules. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owners performed to assess the accrual or (2) evaluating whether the matters that the control owners identified for follow up had been appropriately addressed. As a result, the Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- o During the fourth quarter, the issuer identified that adjustments to the third-quarter accrual balance were needed due to errors. The Firm failed to evaluate the effect of these errors on its conclusions about the effectiveness of the control over the accrual that it tested. (AS No. 5, paragraph 48)

- o The Firm's approach for substantively testing this accrual was to test the accrual balance as of the end of the third quarter, using subsequent payments, and then to roll forward that balance to year end. The Firm's procedures to test the third-quarter accrual balance were insufficient, as only approximately 67 percent of that balance had been paid to customers at the time of its testing, and the Firm's procedures to test the remaining balance, which was multiple times the Firm's established level of materiality, were limited to inquiry. In addition, the Firm's roll-forward testing was limited to testing the mathematical accuracy of the roll-forward schedule, comparing total sales data for the quarter to the issuer's system, testing certain payments that related to the third-quarter accrual balance as discussed above, and inspecting meeting minutes to obtain corroboration of the Firm's understanding of the issuer's process to estimate the accrual. These procedures were insufficient, as the Firm failed to test any of the amount accrued for the fourth quarter;

that amount was multiple times the Firm's established level of materiality. (AS No. 13, paragraphs 8 and 45)

- The Firm's sample size to test revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AU 350, paragraphs .16, .18, .18A, and .23)

A.16. Issuer P

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as follows –

- The issuer recognized a substantial portion of its revenue from contracts that were accounted for using the POC method, and the Firm identified a fraud risk related to the significant use of estimates in calculating the revenue to be recognized using this method. The Firm's procedures to test this revenue were insufficient, as its procedures to test the estimated costs to complete these contracts were limited to (1) comparing actual costs and gross margins to the original estimates for contracts that had been completed, (2) inquiring of management, (3) tracing estimated costs to complete and expected gross margins to supporting documents that had not been tested, (4) comparing financial results to the results for prior periods to identify contracts that contributed to changes in the overall gross margin and inquiring regarding those contracts, and (5) for certain contracts with higher estimated gross margins that were open at the end of the prior year, performing a retrospective analysis of gross margins. These procedures failed to sufficiently address the reasonableness of the estimates of the costs to complete the contracts that were open as of the year end. (AU 342, paragraph .07)

- For one significant component of the issuer, the Firm's sample size to test the occurrence of revenue was too small to provide sufficient evidence because it did not appropriately consider tolerable misstatement for the population. (AU 350, paragraphs .16, .18, .18A, and .23)

A.17. Issuer Q

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The issuer's inventory was subject to periodic cycle counts. The Firm's procedures to test the existence of, and the controls over the existence of, this inventory were insufficient. Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency and that the deviations did not exceed an acceptable level. (AS No. 5, paragraph 39; AU 331, paragraph .11)

B. Auditing Standards

Each deficiency described in Part I.A above could relate to several provisions of the standards that govern the conduct of audits. The paragraphs of the standards that are cited for each deficiency are those that most directly relate to the deficiency. The deficiencies also relate, however, to other paragraphs of those standards and to other auditing standards, including those concerning due professional care, responses to risk assessments, and audit evidence.

Many audit deficiencies involve a lack of due professional care. AU 230, *Due Professional Care in the Performance of Work*, paragraphs .02, .05, and .06, requires the independent auditor to plan and perform his or her work with due professional care and sets forth aspects of that requirement. AU 230, paragraphs .07 through .09, and AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 7, specify that due professional care requires the exercise of professional skepticism. These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13, paragraphs 3, 5, and 8, requires the auditor to design and implement audit responses that address the risks of material misstatement. AS No. 15, *Audit Evidence*, paragraph 4, requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of ICFR) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

The paragraphs of the standards that are described immediately above are not cited in Part I.A, unless those paragraphs are the most directly related to the relevant deficiency.

B.1. List of Specific Auditing Standards Referenced in Part I.A

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited. For each auditing standard, the table also provides the number of distinct deficiencies for which the standard is cited for each of the relevant issuer audits. This information identifies only the number of times that the standard is referenced, regardless of whether the reference includes multiple paragraphs or relates to multiple financial statement accounts.

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	Issuer A	6
	Issuer B	4
	Issuer C	5
	Issuer D	4
	Issuer E	2
	Issuer F	3
	Issuer G	5
	Issuer H	5
	Issuer I	8
	Issuer J	1
	Issuer K	2
	Issuer L	4
	Issuer N	1
	Issuer O	2
	Issuer Q	1
AS No. 11, *Consideration of Materiality in Planning and Performing an Audit*	Issuer C	1
	Issuer H	1

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
	Issuer I Issuer J	1 1
AS No. 12, *Identifying and Assessing Risks of Material Misstatement*	Issuer G	1
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer A Issuer B Issuer C Issuer D Issuer E Issuer G Issuer H Issuer L Issuer M Issuer O	3 1 1 1 3 2 1 1 2 1
AS No. 14, *Evaluating Audit Results*	Issuer A Issuer F	1 2
AU 316, *Consideration of Fraud in a Financial Statement Audit*	Issuer A	1
AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*	Issuer I	1
AU 328, *Auditing Fair Value Measurements and Disclosures*	Issuer B Issuer F	2 1
AU 329, *Substantive Analytical Procedures*	Issuer M Issuer N	2 3
AU 330, *The Confirmation Process*	Issuer A	1
AU 331, *Inventories*	Issuer A Issuer B Issuer D Issuer Q	2 1 1 1
AU 342, *Auditing Accounting Estimates*	Issuer B Issuer C Issuer E Issuer F	1 1 1 1

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
	Issuer H	1
	Issuer I	2
	Issuer J	1
	Issuer K	1
	Issuer P	1
AU 350, *Audit Sampling*	Issuer A	1
	Issuer C	1
	Issuer D	1
	Issuer E	1
	Issuer F	1
	Issuer G	1
	Issuer H	1
	Issuer K	1
	Issuer L	1
	Issuer O	1
	Issuer P	1

B.2. Financial Statement Accounts or Auditing Areas Related to Identified Audit Deficiencies

The table below lists the financial statement accounts or auditing areas related to each deficiency included in Part I.A of this report and identifies the audits described in Part I.A where deficiencies relating to the respective areas were observed.[3] The following standards were cited for only one issuer and are excluded from the table: AS No. 12, AU 316, AU 322, and AU 330.[4]

[3] Certain deficiencies that affect multiple accounts or areas, such as those related to the evaluation of control deficiencies, are excluded from this table, but are included in Appendix C.

[4] The AS No. 12 issue for issuer G related to revenue. The AU 316 issue for issuer A related to revenue. The AU 322 issue for issuer I related to other long-lived assets. The AU 330 issue for issuer A related to inventory.

	AS No. 5	AS No. 11	AS No. 13	AS No. 14	AU 328	AU 329	AU 331	AU 342	AU 350
Accruals and other reserves	K, O		O						
Business combinations, including contingent consideration	F, G, L								
Fixed assets	N								
Impairment of goodwill and intangible assets	F			F	F				
Income taxes	F, N			F				F	
Insurance reserves	K								
Inventory and related reserves	A, B, D, F, G, K, Q		A, B, D, M			M	A, B, D, Q	B, K	D
Investment securities	C		C						C
Materiality		C, H, I, J							
Loans, including ALL	C, H, I, J		H					C, H, I, J	H
Other long-lived assets	I								
Post-retirement benefit obligations and related assets	B				B				
Revenue, including accounts receivable, deferred revenue, and allowances	A, D, E, F, G, L		A, D, E, G, L, M	A		M, N		E, P	A, D, E, F, G, K, L, O, P

B.3. Audit Deficiencies by Industry

The table below lists the industries[5] of the issuers for which audit deficiencies were discussed in Part I.A of this report, along with the specific auditing standards related to the deficiencies and the number of issuer audits where those deficiencies

5 The majority of industry sector data is based on Global Industry Classification Standard ("GICS") data obtained from Standard & Poor's ("S&P"). In instances where GICS for an issuer is not available from S&P, classifications are assigned based upon North American Industry Classification System data.

were observed.[6] Because an issuer audit may have deficiencies that relate to more than one standard, the total for each row should not be read as the total number of issuers.

	AS No. 5	AS No. 11	AS No. 12	AS No. 13	AS No. 14	AU 316	AU 322	AU 328	AU 329	AU 330	AU 331	AU 342	AU 350
Consumer Discretionary	2								1			1	1
Consumer Staples	1		1	1									1
Financial Services	4	4		2			1					4	2
Health Care	1			2				1	1		1	1	
Industrials	2			2							1	1	3
Information Technology	2				1			1			1	1	1
Materials	2			2	1	1				1	1		2
Other	1			1								1	1

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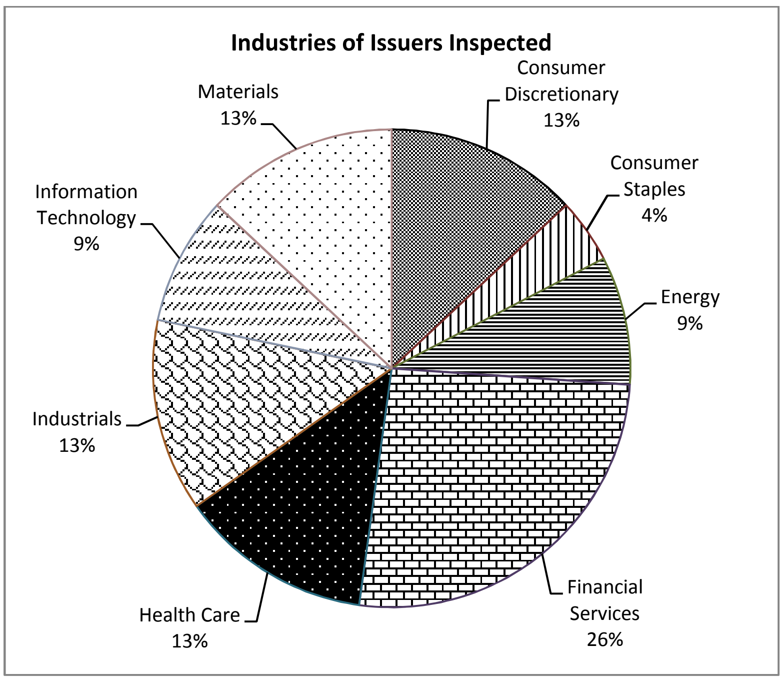
[6] Where identifying the industry of the issuer may enhance the understanding of the description of a deficiency in Part I.A, industry information is also provided there, unless doing so would have the effect of making the issuer identifiable.

C. Data Related to the Issuer Audits Selected for Inspection[7]

C.1. Industries of Issuers Inspected

The chart below categorizes the 23 issuers whose audits were inspected in 2014, based on the issuer's industry.[8]



Industry	Number of Audits Inspected	Percentage
Consumer Discretionary	3	13%
Consumer Staples	1	4%
Energy	2	9%
Financial Services	6	26%
Health Care	3	13%
Industrials	3	13%
Information Technology	2	9%
Materials	3	13%

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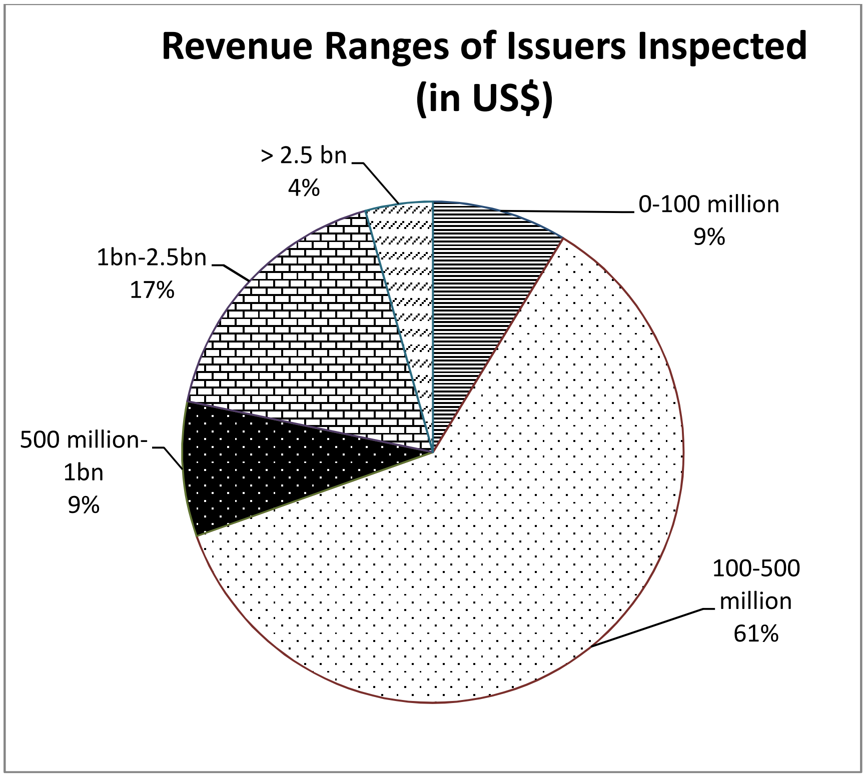
7 Where the audit work inspected related to an engagement in which the Firm played a role but was not the principal auditor, the industry and the revenue included in the tables and charts in this section are those of the entity for which an audit report was issued by the primary auditor. As discussed above, the inspection process included reviews of portions of 22 selected issuer audits completed by the Firm and the Firm's audit work on one other issuer audit engagement in which it played a role but was not the principal auditor.

8 See Footnote 5 for additional information on how industry sectors were classified.

C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 23 issuers whose audits were inspected in 2014.[9] This presentation of revenue data is intended to provide information about the size of issuer audits that were inspected and is not indicative of whether the inspection included a review of the Firm's auditing of revenue in the issuer audits selected for review.



Revenue (in US$)	Number of Audits inspected	Percentage
<100 million	2	9%
100-500 million	14	61%
500 million -1 billion	2	9%
1-2.5 billion	4	17%
> 2.5 billion	1	4%

9 The revenue amounts reflected in the chart are for the issuer's fiscal year end that corresponds to the audit inspected by the PCAOB. The revenue amounts were obtained from S&P and reflect a standardized approach to presenting revenue amounts.

D. Information Concerning PCAOB Inspections that is Generally Applicable to Annually Inspected Firms

Board inspections include reviews of certain portions of selected audit work performed by the inspected firm and reviews of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects 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. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

D.1. Reviews of Audit Work

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of ICFR. For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[10] as well as a firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection of an annually inspected firm does not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. 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 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. In reaching its conclusions, an inspection team considers whether audit documentation or any other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

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[10] 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 the applicable financial reporting framework, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[11]

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on 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.

D.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* provides that an auditing firm has a responsibility to ensure that its personnel comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audits. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable

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[11] 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. In addition, 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 for purposes of imposing legal liability.

assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion or a failure to obtain sufficient appropriate audit evidence to fulfill the objectives of the firm's role in an audit may indicate a defect or potential defect in a firm's quality control system.[12] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[13] related firm methodology, guidance, and practices; and possible root causes.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. The inspection team customizes the procedures it performs with respect to the firm's practices, policies, and processes related to audit quality, bearing in mind the firm's structure, procedures performed in prior inspections, past and current inspection observations, an assessment of risk related to each area, and other factors. The areas generally considered for review include (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 issuer audit engagements, 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

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[12] Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report does not discuss every audit deficiency the inspection team identified.

[13] An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

foreign affiliates perform on the foreign operations of the firm's U.S. issuer audits; 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 defects or potential defects in quality control. A description of the procedures generally applied to these areas is below.

D.2.a. Review of Management Structure and Processes, Including the Tone at the Top

Procedures in this area are designed to focus on (1) how management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance and (2) whether actions and communications by the firm's leadership – the tone at the top – demonstrate a commitment to audit quality. To assess this area, the inspection team may interview members of the firm's leadership and review significant management reports and documents, as well as information regarding financial metrics and other processes that the firm uses to plan and evaluate its business.

D.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 are designed to focus on (1) 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 distinct from marketing or other activities of the firm; (2) the firm's processes for allocating its partner resources; and (3) the accountability and responsibilities of the different levels of firm management with respect to partner management. The inspection team may interview members of the firm's management and review documentation related to certain of these topics. In addition, the inspection team's evaluation may include the results of interviews of audit partners regarding their responsibilities and allocation of time. Further, the inspection team may review a sample of partners' personnel files.

D.2.c. Review of Policies and Procedures for Considering and Addressing the Risks Involved in Accepting and Retaining Issuer Audit Engagements, Including the Application of the Firm's Risk-Rating System

The inspection team may consider the firm's documented policies and procedures in this area. In addition, the inspection team may select certain issuer audits to (1) evaluate compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the issuer audit engagements and (2) observe whether the audit procedures were responsive to the risks identified during the firm's process.

D.2.d. Review of Processes Related to a Firm's Use of Audit Work that the Firm's Foreign Affiliates Perform on the Foreign Operations of the Firm's U.S. Issuer Audits

The inspection team may review the firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the firm's U.S. issuer audits, review available information relating to the most recent internal inspections of foreign affiliated firms, interview members of the firm's leadership, and review the U.S. engagement teams' supervision concerning, and procedures for control of, the audit work that the firm's foreign affiliates performed on a sample of audits.

D.2.e. Review of a 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 Defects or Potential Defects in Quality Control

D.2.e.i. Review of Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance

Procedures in this area are 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 may interview members of the firm's management and review documents relating to the firm's identification and evaluation of, and response to, possible indicators of deficiencies in audit performance. In addition, the inspection team may review documents related to the design, operation, and evaluation of findings of the firm's internal inspection program, and may compare the results of its review of audit work to those from the internal inspection's review of the same audit work.

D.2.e.ii. Review of Response to Defects or Potential Defects in Quality Control

The inspection team may review steps the firm has taken to address possible quality control deficiencies and assess the design and effectiveness of the underlying processes. In addition, the inspection team may inspect audits of issuers whose audits had been reviewed during previous PCAOB inspections of the firm to ascertain whether the audit procedures in areas with previous deficiencies have improved.

D.2.e.iii. Review of Certain Other Policies and Procedures Related to Monitoring Audit Quality

The inspection team may assess policies, procedures, and guidance related to aspects of independence requirements and the firm's consultation processes, as well as the firm's compliance with these requirements and processes. In addition, the inspection team may review documents, including certain newly issued policies and procedures, and interview firm management to consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

END OF PART I

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

APPENDIX B

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.[14]

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14 The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. 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.

Tel: 212-885-8000
Fax: 212-697-1299
www.bdo.com

100 Park Avenue
New York, NY 10017

December 11, 2015

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

Re: Response to Part I of the Draft Report on the 2014 Inspection of BDO USA, LLP

Dear Ms. Munter:

We appreciate this opportunity to provide our response to Part I of the draft Report of the Public Company Accounting Oversight Board ("PCAOB") on the 2014 inspection of BDO USA, LLP. We support the PCAOB's inspection process and their goal of improving audit quality.

We have evaluated each of the matters described in Part I of the draft Report and have taken appropriate actions under both PCAOB standards and our policies, including steps 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 Auditor's Report.*

We remain committed to improving our audit performance and our underlying quality control systems. We look forward to continuing to work with the PCAOB on the most effective means of achieving this objective.

Respectfully submitted,

BDO USA, LLP

APPENDIX C

AUDITING STANDARDS REFERENCED IN PART I

This appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this appendix, and any other Notes, are from the original auditing standards that are referenced. While this appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at http://pcaobus.org/STANDARDS/Pages/default.aspx.

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
PLANNING THE AUDIT		
Using the Work of Others		
AS No. 5.19	The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.	Issuer I
USING A TOP-DOWN APPROACH		
Selecting Controls to Test		
AS No. 5.39	The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.	Issuers A, B, C, D, E, F, G, H, I, J, K, L, N, O, and Q
TESTING CONTROLS		
Testing Design Effectiveness		
AS No. 5.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For	Issuers A, B, C, D, E, F, G, H, I, J, K, L, N, and O

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.	
Testing Operating Effectiveness		
AS No. 5.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	Issuers A, B, C, D, E, F, G, H, I, J, K, L, N, and O
Relationship of Risk to the Evidence to be Obtained		
AS No. 5.48	When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.	Issuer O
AS No. 5.55	*Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.	Issuers A, H, and I
AS No. 5.56	The additional evidence that is necessary to	Issuers A, H, and

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	update the results of testing from an interim date to the company's year-end depends on the following factors – • The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests; • The sufficiency of the evidence of effectiveness obtained at an interim date; • The length of the remaining period; and • The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date. Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.	I
EVALUATING IDENTIFIED DEFICIENCIES		
AS No. 5.68	The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.	Issuers A, C, and G
APPENDIX B - Special Topics		
INTEGRATION OF AUDITS		
AS No. 5.B8	*Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum – • The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.	Issuer H

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	• Findings with respect to illegal acts and related party transactions. • Indications of management bias in making accounting estimates and in selecting accounting principles. • Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.	
AS No. 5.B9	To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.	Issuers F and I
USE OF SERVICE ORGANIZATIONS		
AS No. 5.B19	AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include - a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.	Issuer H

AS No. 11, *Consideration of Materiality in Planning and Performing an Audit*		
Considering Materiality In Planning and Performing an Audit		
ESTABLISHING A MATERIALITY LEVEL FOR THE FINANCIAL STATEMENTS AS A WHOLE		

AS No. 11, *Consideration of Materiality in Planning and Performing an Audit*		
AS No. 11.6	To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount. Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.	Issuers C, H, I, and J

AS No. 12, *Identifying and Assessing Risks of Material Misstatement*		
Factors Relevant to Identifying Fraud Risks		
AS No. 12.65	The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in this paragraph, which generally are present when fraud exists. Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.	Issuer G

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
Responses Involving the Nature, Timing, and Extent of Audit Procedures		
AS No. 13.8	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers A, E, and O
Testing Controls		
TESTING CONTROLS IN AN AUDIT OF FINANCIAL STATEMENTS		
AS No. 13.16	*Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.	Issuers C, D, G, H, and L
Footnotes to AS No. 13.16 12/ Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures. 13/ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.		
AS No. 13.18	*Evidence about the Effectiveness of Controls in the Audit of Financial Statements*. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.	Issuers C, D, G, H, and L

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
Substantive Procedures		
AS No. 13.36	The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.	Issuer M
AS No. 13.37	As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.	Issuers C, D, G, H, and L
EXTENT OF SUBSTANTIVE PROCEDURES		
AS No. 13.42	The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.	Issuer E
TIMING OF SUBSTANTIVE PROCEDURES		
AS No. 13.45	When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.	Issuers B, M, and O
AS No. 13.46	If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the	Issuers A and G

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
	remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.	

AS No. 14, *Evaluating Audit Results*		
Evaluating the Results of the Audit of Financial Statements		
AS No. 14.3	In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.	Issuer F
ACCUMULATING AND EVALUATING IDENTIFIED MISSTATEMENTS		
AS No. 14.14	*Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be modified if : a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or b. The aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit.[6/] Note: When the aggregate of accumulated misstatements approaches the materiality level or levels used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when combined with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.	Issuer A

AS No. 14, *Evaluating Audit Results*		
Footnotes to AS No. 14.14 [6/] Accounting Standard No. 11		
AS No. 14.19	The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard	Issuer A

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
Responding to Assessed Fraud Risks		
Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls		
AU 316.61	The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider: • *The auditor's assessment of the fraud risk.* The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary. • *The effectiveness of controls that have been implemented over journal entries and other adjustments.* Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include	Issuer A

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	the identification and substantive testing of specific items. • *The entity's financial reporting process and the nature of the evidence that can be examined.* The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested. • *The characteristics of fraudulent entries or adjustments.* Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or a consistent ending number. • *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (a) contain	

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to errors in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain intercompany transactions, or (f) are otherwise associated with an identified fraud risk. In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, *Audit Planning.* • *Journal entries or other adjustments processed outside the normal course of business.* Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity's internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments such as consolidating adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity's internal controls. Accordingly, the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.	

AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*		
Extent of the Effect of the Internal Auditors' Work		
AU 322.20	In making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor considers— *a.* The materiality of financial statement amounts—that is, account balances or	Issuer I

AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*		
	classes of transactions. *b.* The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to these financial statement amounts. c. The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions.[fn 7] As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.	
Footnote to AU 322.20 [fn 7] For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions.		
AU 322.21	For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.	Issuer I
Evaluating and Testing the Effectiveness of Internal Auditors' Work		
AU 322.26	In making the evaluation, the auditor should test some of the internal auditors' work related to the significant	Issuer I

AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*		
	financial statement assertions. These tests may be accomplished by either (*a*) examining some of the controls, transactions, or balances that the internal auditors examined or (*b*) examining similar controls, transactions, or balances not actually examined by the internal auditors. In reaching conclusions about the internal auditors' work, the auditor should compare the results of his or her tests with the results of the internal auditors' work. The extent of this testing will depend on the circumstances and should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the internal audit work being considered by the auditor.	

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Introduction		
AU 328.03	The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." [fn 1] Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.	Issuer B
Footnote to AU 328.03 [fn 1] Generally accepted accounting principles (GAAP) contain various definitions of fair value. However, all of the definitions reflect the concepts in the definition that appears in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. For example, Governmental Accounting Standards Board Statement of Governmental Accounting Standards No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, defines fair value as "the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."		

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AU 328.26	The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06). b. The fair value measurement was determined using an appropriate model, if applicable. c. Management used relevant information that was reasonably available at the time.	Issuer F
AU 328.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.	Issuer F
AU 328.36	To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),[fn 5] individually and taken as a whole, need to be realistic and consistent with: a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances; b. Existing market information; c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies; d. Assumptions made in prior periods, if appropriate; e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable; f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and	Issuer F

AU 328, *Auditing Fair Value Measurements and Disclosures*		
	g. The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate. Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.	
Footnote to AU 328.36 fn 5 The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).		
Disclosures About Fair Values		
AU 328.43	The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.[fn 8] Disclosure of fair value information is an important aspect of financial statements. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required under GAAP, some entities disclose voluntary additional fair value information in the notes to the financial statements.	Issuer B
Footnote to AU 328.43 fn 8 See also paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.		

AU 329, *Substantive Analytical Procedures*		
AU 329.05	Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations: a. Financial information for comparable prior period(s) giving consideration to known changes b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or	Issuer N

AU 329, *Substantive Analytical Procedures*		
	annual data c. Relationships among elements of financial information within the period d. Information regarding the industry in which the client operates—for example, gross margin information e. Relationships of financial information with relevant nonfinancial information	
Analytical Procedures Used as Substantive Tests		
Plausibility and Predictability of the Relationship		
AU 329.13	It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.	Issuer N
AU 329.14	As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.	Issuer N
Availability and Reliability of Data		
AU 329.16	Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should	Issuer M

AU 329, *Substantive Analytical Procedures*		
	be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives: • Whether the data was obtained from independent sources outside the entity or from sources within the entity • Whether sources within the entity were independent of those who are responsible for the amount being audited • Whether the data was developed under a reliable system with adequate controls • Whether the data was subjected to audit testing in the current or prior year • Whether the expectations were developed using data from a variety of sources	
Precision of the Expectation		
AU 329.19	Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the client, its size and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.	Issuer N
Investigation and Evaluation of Significant Differences		
AU 329.20	In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances	Issuers M and N

AU 329, *Substantive Analytical Procedures*		
	or classes could aggregate to an unacceptable amount.	
AU 329.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, Evaluating Audit Results.)	Issuer N

AU 330, *The Confirmation Process*		
Alternative Procedures		
AU 330.31	When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, the omission of alternative procedures may be acceptable (a) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (b) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated.	Issuer A
Evaluating the Results of Confirmation Procedures		
AU 330.33	After performing any alternative procedures, the auditor should evaluate the combined evidence provided by the confirmations and the alternative procedures to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions. In performing that evaluation, the auditor should consider (a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request	Issuer A

AU 330, *The Confirmation Process*		
	additional confirmations or extend other tests, such as tests of details or analytical procedures.	

AU 331, *Inventories*		
Inventories		
AU 331.09	When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.	Issuer A
AU 331.11	In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [Revised, June 1981, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 39.]	Issuers D and Q
AU 331.12	When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs .09 through .11, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with inspection of the records of any client's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.	Issuer B

AU 331, *Inventories*		
Inventories Held in Public Warehouses [fn3]		
AU 331.14	If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets, to obtain reasonable assurance with respect to their existence, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances. *a.* Test the owner's procedures for investigating the warehouseman and evaluating the warehouseman's performance. *b.* Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable. *c.* Observe physical counts of the goods, if practicable and reasonable. *d.* If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).	Issuer A
Footnote to AU 331 [fn 3] See section 901 for Special Report of Committee on Auditing Procedure.		

AU 342, *Auditing Accounting Estimates*		
Evaluating Accounting Estimates		
AU 342.07	The auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate evidential matter to provide reasonable assurance that— a. All accounting estimates that could be material to the financial statements have been developed. b. Those accounting estimates are reasonable in the circumstances. c. The accounting estimates are presented in conformity with applicable accounting principle [fn 2] and are properly disclosed.[fn 3]	Issuers E and P

AU 342, *Auditing Accounting Estimates*		
Footnotes to AU 342.07 fn 2 Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.] fn 3 See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.		
Evaluating Reasonableness		
AU 342.11	Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach: a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests. c. Consider whether there are additional key factors or alternative assumptions about the factors. d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose. f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions. g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the	Issuers B, C, F, H, I, J, and K

AU 342, *Auditing Accounting Estimates*		
	Work of a Specialist). i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.	

AU 350, *Audit Sampling*		
Sampling In Substantive Tests Of Details		
Planning Samples		
AU 350.16	When planning a particular sample for a substantive test of details, the auditor should consider • The relationship of the sample to the relevant audit objective. • Tolerable misstatement. (See paragraphs .18-.18A.) • The auditor's allowable risk of incorrect acceptance. • Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.	Issuers A, D, F, K, L, O, and P
AU 350.18	Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the account balance or class of transactions is called *tolerable misstatement*.	Issuers A, D, F, K, L, O, and P

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AU 350.18A	Paragraphs 8 - 9 of Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.	Issuers A, D, F, K, L, O, and P
AU 350.19	The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.[fn 3] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	Issuers C, D, G, H, and L
Footnote to AU 350.19 [fn 3] Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.		
AU 350.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of	Issuers A, C, D, E, F, G, H, K, L, O, and P

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	the population, including the expected size and frequency of misstatements.	
AU 350.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuers C, D, E, G, H, and L