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REPORT ON THE PCAOB'S 2004, 2005, 2006, AND 2007 INSPECTIONS OF DOMESTIC ANNUALLY INSPECTED FIRMS[1/]

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This report discusses observations identified by the Public Company Accounting Oversight Board ("PCAOB" or "Board") in the course of its 2004, 2005, 2006, and 2007 inspections of the eight domestic registered firms that have been inspected every year since the PCAOB's inspection program began.[2/] The report is a summary discussion of certain issues identified in reports on inspections of such firms, as well as of certain efforts firms have represented that they have made to remediate possible defects in their quality control systems.

[1/] Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Sarbanes-Oxley Act of 2002 ("the Act"). Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such report may identify the firm or firms to which any quality control criticisms in the report relate.

[2/] Section 104(b) of the Act states that registered public accounting firms that regularly provide audit reports for more than 100 issuers shall be inspected annually. Under Board rules, registered public accounting firms that issue audit reports for more than 100 issuers in any calendar year are inspected by the PCAOB in the following calendar year. These are referred to as "annual inspections," as distinguished from inspections of firms that issue audit reports for 100 or fewer issuers, which must be conducted at least once every three years. The Board's observations in this report are based on information obtained in the course of annual inspections of those eight domestic firms that were inspected every year from 2004 through 2007 ("the four-year period"). These firms are BDO Seidman, LLP; Crowe Chizek and Company LLC; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen, LLP; and PricewaterhouseCoopers LLP. They will be referred to as either the "domestic annually inspected firms" or simply "the firms" throughout the remainder of this report.

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Overview

This report covers four years of inspections. These inspections generally involved the review of audits of financial statements for 2003 through 2006. The approach to inspections and inspection reports necessarily evolved from the first year of full inspections – the first year covered by this report – through the most recently completed full year of inspections. For this reason, attempting to draw conclusions based on the sheer number of deficiencies cited in the reports, overall or in any particular subject area, should be approached with caution. Nonetheless, certain trends have emerged:

- Inspectors continue to find deficiencies in important audit areas, both established and emerging. These areas include critical and high-risk parts of audits, such as revenue, fair value, management's estimates, and the determination of materiality and audit scope. These deficiencies occurred in audits of issuers of all sizes, including in some of the larger audits they reviewed. In some cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results. In addition, even in areas where inspectors have observed general improvement, deficiencies continue to arise. The inspectors will continue to focus on the significant areas where they have encountered deficiencies.

- In certain well-established audit areas, such as the confirmation of accounts receivable and the auditing of income tax accounts, the incidence of deficiencies encountered has declined. In certain other areas, such as the performance of analytical procedures, the nature of the deficiencies identified by inspectors has generally narrowed during the four-year period, with fewer of them relating to the overall failure to apply the governing standard and more relating to only one or a few aspects of the standard. In addition, inspectors have, in recent years, reviewed some audits of issuers whose audits had been reviewed in prior years in order to evaluate whether performance in the areas commented upon in prior years had improved. In the majority of these specific audits, inspectors observed improvement in the auditing of those areas.

- In response to the identification, during the inspection process, of quality control deficiencies, firms have changed their audit methodologies, processes, or related quality control systems.

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This report contains descriptions of audit areas where the inspectors found deficiencies and, for each area, examples of specific deficiencies. This compilation is provided in order to inform the public about the nature of inspection observations for these firms during the four-year period, so that readers of this report will have greater knowledge of the areas in which the firms have encountered challenges in their auditing over the last four years. The list of areas also provides insight as to where inspectors have focused attention, and where firms have directed their efforts on improving future performance.[3/]

While the Board is issuing this report to provide information about specific inspection observations, the Board cautions against using this report to draw broad conclusions about the quality of audits performed by any (or all) of these firms. The total number of audits reviewed during the four-year period, while substantial, constituted a relatively small portion of the total audits of issuers performed by these firms, and the selection of audits for review was not, and was not intended to be, a representative sample of the audits that the firms performed. In addition, a review of an audit generally encompassed only certain aspects of the firm's performance of that audit. These aspects were selected based principally on perceived risk.

This report contains four sections. First is a brief description of the domestic annually inspected firms. Next is a discussion of the inspection process. Following that, the areas of frequent deficiencies are described, along with specific examples of the auditing deficiencies. Finally, this report describes the remediation process and summarizes certain firm responses. This section highlights some of the changes the firms have made in an effort to improve audit quality.

[3/] The auditing areas discussed in this report were selected based on the number of times that inspectors encountered deficiencies that were described in a report on an inspection of a domestic annually inspected firm. The discussion of each auditing area includes examples of the types of deficiencies inspectors have encountered in the area. These illustrative deficiencies are significant enough to merit public discussion, even though some of them may have been observed in the inspection of only one firm. Therefore, the inclusion of a deficiency should not be taken to mean that the inspection teams found this deficiency in all of their inspections, or even a majority of them.

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The Domestic Annually Inspected Firms

The domestic annually inspected firms vary in size. The four largest, as a group, audit issuers[4/] representing approximately 98 percent of the total market capitalization of issuers that are based in the U.S. The smaller four, as a group, audit issuers representing approximately one percent of the total U.S.-based issuer market capitalization. Each of the four larger firms audits between approximately 10 and approximately 18 percent of the total number of U.S.-based issuers, and each of the smaller four audits issuers representing between approximately one to approximately eight percent of the total number of U.S.-based issuers. Collectively, the firms audit approximately 66 percent of the U.S.-based issuers.[5/] Each of these firms has numerous offices located in various cities in the United States, and each is a member of an international network of accounting firms. These international networks have members throughout the world that may be involved in auditing the firms' international clients.

The Inspection Process

The PCAOB's inspection program commenced in 2003 with limited inspection procedures performed at the four largest U.S. firms, and the PCAOB began conducting full inspections in 2004. The PCAOB's inspection process uses two techniques to assess firms' audit quality. First, inspectors review a firm's work on numerous audits – selected by the PCAOB, without the firm being able to resist or influence any selection. Second, inspectors evaluate certain of the firm's quality control policies and procedures that could be expected to have an effect on audit performance.

The inspection program has evolved since 2003 and emphasized different areas from year to year, as the inspection staff has grown in size, developed a growing set of observations regarding the strengths and weaknesses of the firms inspected, and refined and reassessed its perception of risk within these audit firms, in particular with

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4/ The term "issuer" encompasses, in general, public companies, investment companies, and certain employee benefit plans. The precise definition of "issuer" can be found in section 2(a)(7) of the Act.

5/ All issuer and market capitalization statistics in this paragraph are as of December 31, 2007, and are based on information provided by AuditAnalytics.com and Standard and Poor's, a division of McGraw-Hill.

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respect to the likelihood of misstatements in financial reports. Overall, the number of issuer audits inspected has fluctuated, while the average size of the issuers' market capitalizations and the complexity of the audits reviewed generally have increased. The aggregate number of issuer audits inspected during the four-year period and their average market capitalization are set forth in the table below.

Year	Number of Issuer Audits Inspected[6/]	Average Market Capitalization of Issuer Audits Inspected[7/]
2004	521	$1.9 billion
2005	348	$3.6 billion
2006	351	$4.9 billion
2007	442	$4.2 billion

The market capitalization of issuer audits inspected, by year, is set forth below.

	$0 – $100M	$100 - $500M	$500M - $1B	$1B - $5B	> $5B
2004	170	126	72	111	42
2005	54	112	59	89	34
2006	51	102	54	89	55
2007	24	118	92	145	63

6/ The number of issuers inspected was not divided evenly among the eight firms, nor was the number consistent from year to year for any one firm. The inspection of an audit normally is limited to only certain aspects of the audit, which are selected based principally on perceived risk.

7/ Issuer market capitalization is as of December 31st for each year for those issuers that had readily determinable market capitalization and is derived from data provided by Standard and Poor's, a division of McGraw-Hill.

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The selection of issuer audits to inspect has been influenced by the evaluation of the risk of material misstatement of financial statements. Risk may be related to characteristics of the particular issuer or its industry; the audit issues likely to be encountered; firm-, practice office-, or individual partner-level considerations; prior inspection results; or other factors. The issuer audits inspected in each year involved numerous industry sectors.

In reviewing audits, inspectors evaluate the work that the auditors performed. Inspectors assess whether the auditors conducted the audit in accordance with applicable PCAOB standards. Inspectors also assess whether the auditors appropriately addressed any departures from accounting standards in the financial statements that relate to the audit areas selected for review. Failures identified by the inspectors are described in inspection reports.

As noted above, and pursuant to the Act, the inspection process includes a review of the quality control systems of the firms. The specific areas of the quality control systems that inspection procedures have addressed include the following:

- tone at the top;
- practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions;
- independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees;
- practices for client acceptance and retention;
- practices for consultations on accounting, auditing, and Securities and Exchange Commission ("SEC") matters;
- the firm's internal inspection program;
- practices for establishment and communication of audit policies, procedures, and methodologies, including training;
- policies and procedures for staffing audits; and

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- the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. issuer audit clients.

A more detailed description of the inspection procedures, both with respect to these functional areas and with respect to reviews of issuer audits, appears in a public appendix to each report.

During the inspection process, members of the inspection teams discuss the issues identified with representatives of the firm. Typically, observations concerning audit performance are discussed initially with members of the engagement team, but these issues may concurrently or subsequently be explored with the person who coordinates the inspection on behalf of the firm, the firm's national office experts, and, in some cases, the firm's senior management, including the managing partner or chief executive officer of the firm. Significant issues that are not resolved through inspection procedures and discussions during inspection field work result in the issuance of comment forms, to which the firms respond in writing. These responses and the issues identified are carefully considered by the inspection team and other members of the inspection staff for possible inclusion in the report on the inspection, as well as any additional action deemed necessary.

Pursuant to the Act, inspection reports include a portion that is available to the public.[8/] The public portion contains descriptions of deficiencies noted (ordinarily on an audit-by-audit basis) that reach a certain level of significance. The threshold for inclusion in the public portion of an inspection report is that the deficiency is of such significance that it appeared to the inspection team that the firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements.[9/]

Pursuant to the Act, if an inspection gives rise to concerns about a firm's quality control system, the issues are described in a nonpublic portion of the report. While not every deficiency in auditing that the inspection team observes may be indicative of a quality control defect, certain deficiencies, or repeated instances of a similar deficiency, may support the conclusion that such a defect may exist. Accordingly, the nonpublic

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[8/] See Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2)

[9/] In some cases, when an inspection team identifies serious deficiencies, the matter is referred to the Board's Division of Enforcement and Investigations for its consideration and action, as appropriate.

portion of these reports may include descriptions of certain auditing areas or procedures where the firm's quality controls may need improvement. These descriptions can be based both on deficiencies that met the level of significance to be included in the public portion and other potentially consequential deficiencies. The nonpublic portion of the reports also may include criticisms of the firm's quality controls related to the specific areas of the quality control systems that were reviewed.[10/]

The Act provides that any discussion of defects in, or criticisms of, a firm's quality control system that are in the nonpublic portion of an inspection report will remain nonpublic, unless the firm fails to address them to the Board's satisfaction within 12 months of the date of the issuance of that report.[11/] The process for addressing the defects or criticisms is referred to as remediation. To date, all of the domestic annually inspected firms have submitted to the PCAOB evidence of their remediation of defects noted in their 2004 and 2005 inspection reports.

[10/] For additional information about inspection reports generally, see PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (Aug. 26, 2004).

[11/] Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2)

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The Board's Observations[12]

This report describes some of the more significant or common deficiencies[13] that were in the public and the nonpublic portions of certain of the reports on the 2004 through 2007 inspections of the domestic annually inspected firms. This report includes observations that the Board has previously made public, as well as observations that have not been made public but that were communicated to the applicable firm in its report's discussion of the firm's quality control system.

These observations are divided into three sections: (1) departures from GAAP, (2) auditing deficiencies, and (3) deficiencies in certain quality control functional areas. The discussion of auditing deficiencies also includes some general observations about some of the possible root causes of the deficiencies observed.

12/ This report does not discuss deficiencies related to firms' compliance with AU 316, *Consideration of Fraud in a Financial Statement Audit*. This topic was discussed in PCAOB Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (Jan. 22, 2007). This report also does not discuss issues related to the firms' implementation of AS No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* This topic was discussed in PCAOB Releases No. 2005-023, *Report on the Initial Implementation of [AS No. 2] (November 3*0, 2005) and 2007-004, *Report on the Second Year Implementation of [AS No. 2]* (April 18, 2007). Finally, this report does not discuss issues related to the firms' implementation of AS No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, which was not in effect for the time period covered by this report.

13/ The discussion in this report of any audit deficiency reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether any firm engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. For additional discussion of this distinction, see PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (Aug. 26, 2004) at 8-9.

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1. Recognizing and Appropriately Addressing Departures from GAAP and Other Financial Reporting Requirements

The inspectors identified instances where firms had failed to identify or appropriately address departures from Generally Accepted Accounting Principles ("GAAP") and other financial reporting requirements. Some of these departures appeared to the inspection teams to be material to the financial statements of the issuers in question, and these departures are described in the public portions of the reports on the applicable firms.[14/] Other such departures are described in the nonpublic portions of certain of the reports.[15/] The GAAP deficiencies cited encompassed a broad range of accounting areas. The most common of such departures were related to income taxes, derivatives, revenues, and cash flow presentations.

2. Auditing Deficiencies

During the inspections of the domestic annually inspected firms, the inspectors identified instances where the firms failed to conduct audits in accordance with PCAOB standards. The areas where this occurred most frequently are described below.

Revenues

In most audits, revenue is an important area of focus. Material misstatements due to fraudulent financial reporting often result from misreporting of revenue. Inspection reports on domestic annually inspected firms have described audit deficiencies related to firms' failures to audit revenue sufficiently, and these failures have related both to basic principles of revenue recognition, such as the timing of booking revenue in connection with the sale of goods, and to revenue issues that are encountered when issuers have complex revenue-generating transactions or

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14/ When the Board becomes aware that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

15/ While these other departures may not have been material to the financial statements already filed, they presented the potential to be material to future financial statements if the accounting was not corrected.

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processes. These more complex transactions or processes include long-term contracts that the issuers accounted for using the percentage-of-completion method, and contractual arrangements with customers that involved multiple products and services that were provided to the customers at different times. In these types of situations, determining the amount of revenue that is appropriate to record in any given period may require detailed analysis and, in some cases, the amount of revenue to record is based on estimates related to future activities.

The inspection teams identified deficiencies in firms' testing of issuers' claims that they had met all of the criteria for revenue recognition.[16/] For example, firms failed to evaluate specific terms in sales contracts, such as customer acceptance provisions or provisions relating to when title passed to the buyer, that could have an effect on when revenue should be recognized.

Inspectors also observed deficiencies when firms were auditing issuers that had more complex revenue-generating transactions or processes. These included the failure to adequately test or evaluate whether (a) the estimated fair values of all elements in multiple-element arrangements governed by Statement of Position ("SOP") 97-2, *Software Revenue Recognition*, as amended, were reasonable, (b) the estimated total costs to complete long-term contracts subject to SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* were reasonable, and (c) the estimated fair values of all elements in arrangements with multiple deliverables governed by Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* were reasonable.

To assess the existence of amounts due from customers, firms commonly request that customers confirm in writing amounts due to the issuer as of a certain date. When amounts due from customers are derived from revenue-generating transactions, these tests also provide evidence about certain aspects of the related revenues. Inspectors identified instances where firms failed to (a) perform appropriate procedures when confirmation replies indicated discrepancies between the amounts that the customer indicated were due and the amounts the issuer indicated were due, or (b) perform appropriate alternative procedures when customers failed to respond to requests for confirmation.[17/] In some instances, firms failed to perform other appropriate

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16/ See SEC Staff Accounting Bulletin No. 104, Revenue Recognition

17/ AU 330, *The Confirmation Process*

substantive procedures to test the recorded amounts due from customers when the firms had chosen not to request confirmations because they had deemed the use of confirmations to be ineffective.

Accounting Estimates

The preparation of financial statements necessarily involves making estimates and assumptions. For example, determining the amounts of allowances for losses on potentially uncollectible amounts due from customers or certain contingent obligations involves estimates and assumptions. Estimates and assumptions also may be necessary to determine the amount of revenues and expenses to record during a given accounting period, as may be the case when sales are made with rights of return, or when future obligations related to, for example, a plant closure or pension benefits, need to be recorded in the current period.

Auditors are responsible for evaluating the reasonableness of accounting estimates made by issuers in the context of the financial statements taken as a whole, and their objective when performing this evaluation is to obtain 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, and (c) the accounting estimates are presented in conformity with GAAP and are properly disclosed.[18/]

To audit an estimate, a firm should first gain an understanding of how management had developed the accounting estimate and then perform one or a combination of the following: (a) review and test the process management used to develop the estimate, (b) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, or (c) review events or transactions occurring after the period covered by the financial statements and before the date of the auditor's report.[19/]

Inspectors observed that the firms often chose to evaluate accounting estimates by reviewing and testing management's process for developing the estimate. In these instances, deficiencies involved failures to (a) obtain an understanding of the

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[18/] AU 342, *Auditing Accounting Estimates,* paragraphs 04 and 07

[19/] AU 342.10

methodology management had used to develop the accounting estimate, (b) test the reasonableness of management's key assumptions, including performing tests beyond inquiries of management, or (c) test the data underlying management's calculation of the accounting estimate.

In other cases, firms chose to develop an independent expectation of the estimate. Inspection teams observed that, when this approach was chosen, firms sometimes failed to support the assumptions or test the underlying data they used in developing the independent expectation.

Auditing Fair Value Measurements

GAAP requires that certain assets and liabilities, such as certain investments in debt and equity securities, derivatives, and assets acquired and liabilities assumed in a business combination, be recorded in financial statements at their fair value. Certain assets need to be evaluated annually (or, depending on the nature of the asset, when events or changes in circumstances warrant) to determine whether their fair value is less than their recorded amount, and their recorded value needs to be reduced.

Auditors should test management's fair value measurements and disclosures. The auditor should consider using the work of a specialist if the auditor does not have the necessary skill and knowledge to plan and perform audit procedures related to fair value.[20/] Observable market prices may exist to assist in testing fair values. Where they do not and other valuation methods are used, the auditor's substantive tests of fair value may involve (a) testing the significant assumptions, the valuation model, and the underlying data, (b) developing an independent estimate of fair value for corroborative purposes or, where applicable, (c) reviewing events or transactions occurring after the period covered by the financial statements and before the date of the auditor's report.[21/]

[20/] AU 328, *Auditing Fair Value Measurements and Disclosures*, paragraphs 20 and 23; AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* paragraph 06. Also, in December 2007, in response to the auditing challenges presented by the subprime credit crisis and the transition to the new fair value accounting standard, the PCAOB staff issued Staff Audit Practice Alert No. 2*, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007), which provides auditors with information about auditing fair value measurements and disclosures.

[21/] AU 328.23; AU 332.40

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Inspection teams observed instances of inadequate testing by firms of fair value estimates in connection with firms' evaluation of the possible impairment of goodwill and other long-lived assets. The inspectors observed instances where firms had not tested the reasonableness of management's significant assumptions and the underlying data that the issuers had used in valuation models. As a result, the auditors did not have sufficient evidence to conclude on the issuers' estimates of fair value. For example, the inspectors identified instances where significant assumptions, such as the future revenue growth rate, operating margins, discount rates, and terminal values, were either not tested at all, or were tested only through discussions with management. In some of these situations, management's assumptions were that revenues would increase significantly in the near future despite evidence to the contrary, such as recent declining revenue trends or known increases in competition in the issuer's industry. Inspection teams also observed instances where firms had not challenged management's conclusions that assets did not need to be tested for impairment, despite evidence of impairment indicators.

Inspection teams also observed instances where firms' procedures to test the fair values of financial instruments, including derivative instruments, loans, and securities, were inadequate. In these instances, deficiencies included (a) the failure to gain an understanding of the methods and assumptions used to develop the fair value measurements of financial instruments that were illiquid or difficult to price, (b) the reliance on issuer-supplied pricing information without obtaining corroboration of that information, and (c) the reliance on confirmation responses from third parties or counterparties that included disclaimers as to their accuracy and appropriateness for use in the preparation of financial statements.

Analytical Procedures

Analytical procedures, when properly designed and applied, can be useful substantive tests of the reasonableness of an account balance. They often consist of comparing an account balance, or a ratio based on the balance, with an expected amount or ratio to determine whether the account balance or ratio appears reasonable. For example, an auditor might compare commission expense with an expected amount computed by multiplying sales by the commission rate. If the difference between the two is above an acceptable range that the auditor has predetermined, the auditor should investigate the reasons for the difference.

In instances where a firm decides to use an analytical procedure as a substantive test, the procedure should comply with all of the requirements for substantive analytical

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procedures. These include (a) developing an expectation for the amount being tested, or a ratio based on that amount, that is precise enough to provide the desired level of assurance, (b) considering the amount of difference from the auditor's expectation that does not need further investigation, and (c) evaluating significant unexpected differences from the auditor's expectation. In this evaluation of significant unexpected differences, the auditor may consider management's responses to the auditor's inquiries, but the auditor ordinarily should obtain other evidence to corroborate the information received.[22/]

The effectiveness of a substantive analytical procedure in identifying potential misstatements depends on a number of factors. For example, the effectiveness of the procedure in a given instance will be affected by (a) the nature of the assertion being tested, (b) the plausibility and predictability of the relationship of the data, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation that the auditor develops.[23/] In areas where significant risks of material misstatement exist, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient,[24/] and, in those situations, the auditor also will need to perform substantive tests of details.

Inspection teams have identified deficiencies in firms' performance of analytical procedures that the firms intended to be substantive tests, including the failure to (a) develop appropriate expectations, including in some instances the failure to appropriately disaggregate data in order to obtain the necessary level of precision for the expectation, (b) establish a threshold for differences that the firm could accept without further investigation, (c) establish a threshold for differences that was low enough to provide the level of assurance that the firm planned to achieve from the test, (d) test the data that the firm used in the analytical procedures, (e) investigate significant unexpected differences from the firm's expectations, and (f) examine other evidence to obtain corroboration of management's explanations regarding significant unexpected differences.

22/ AU 329, *Analytical Procedures,* paragraph 21

23/ AU 329.11

24/ AU 329.09

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Income Taxes

When accounting for income taxes, issuers recognize the amount of taxes payable or refundable for the current year in the financial statements. Issuers also recognize deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in their financial statements or tax returns. At times, the outcome of a tax position may be uncertain, and sometimes it may not be clear whether a deferred tax asset will ultimately result in tax benefits. In these cases, valuation allowances or other reserves, such as tax contingency reserves, may be required so that only the appropriate amount is recorded. When auditing income taxes, firms should determine whether the current year's tax expense (or benefit), as well as all tax-related balance sheet accounts, are recorded, and the disclosures are appropriate, in accordance with GAAP.

Inspection teams have identified deficiencies related to auditing income taxes, including firms' failure to (a) perform any or adequate substantive procedures to test the tax contingency reserves, in some instances by failing to obtain corroboration for management's significant assumptions relating to such reserves; (b) evaluate whether the valuation allowance, which reduced the recorded amount of deferred tax assets, was appropriate; and (c) perform any or adequate substantive procedures to test the existence, completeness, and/or valuation of other income tax accounts, including deferred tax assets.

Internal Control

In all audits, the auditor should obtain an understanding of the issuer's internal control that is sufficient to plan the audit.[25/] If the auditor plans to assess control risk below the maximum level, he or she should perform procedures during the audit to obtain evidence about the effectiveness of both the design and operation of internal controls.[26/] Assessing control risk below the maximum allows the auditor to rely on controls and, in appropriate circumstances, to modify the nature, timing, and extent of the auditor's substantive procedures.

[25/] AU 319, *Consideration of Internal Control in a Financial Statement Audit,* paragraph 02

[26/] See AU 319.03

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Inspection teams identified instances where firms' reliance on internal control was inappropriate because the firms (a) did not test the controls that they relied on, (b) tested the controls for only a portion of the time period for which they relied on the controls, or (c) relied on controls that they had identified as ineffective. In these instances, the firms failed to appropriately alter their assessments of control risk and reconsider the nature, timing, and extent of their substantive procedures. Inspection teams also observed instances where firms relied upon information in reports that were generated from the issuer's computer systems without adequately testing whether the reports were complete and accurate or whether the underlying systems that generated the reports could be relied on.

When an issuer uses an outside service organization to process certain transactions, the issuer's auditor may obtain evidence about the effectiveness of the service organization's controls, and in turn rely on those controls to reduce his or her assessment of control risk, by: (a) performing tests of the issuer's controls over the activities of the service organization, (b) obtaining a service auditor's report on controls placed in operation at the service organization and tests of their operating effectiveness, or obtaining an agreed-upon procedures report that describes relevant tests of controls, and/or (c) performing tests of controls at the service organization.[27/]

Inspection teams found deficiencies in firms' procedures regarding reliance on internal controls at service organizations. These deficiencies included the failure to: (a) obtain and evaluate a service auditor's report, or perform other procedures to be able to rely on controls at the service organization, (b) test the issuer's controls that are necessary to support reliance on controls at the service organization, and (c) perform appropriate procedures when the service auditor's report that the firm obtained did not cover a sufficient amount of the period subject to audit.

Audit Sampling

Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class of transactions.[28/] The inspection teams identified deficiencies in firms' performance of audit sampling, including (a) using

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[27/] AU 324, *Service Organizations*, paragraph 12

[28/] AU 350, *Audit Sampling,* paragraph 01 sample sizes that were too small to obtain enough evidence to form a conclusion about the account balance or class of transactions being tested, (b) failing to appropriately project the effect of errors identified when testing the items selected to the entire population, (c) failing to select the sample in such a way that it could be expected to be representative of the underlying population, and (d) not appropriately testing all the items in the sample.

Use of the Work of Specialists

A firm might seek to use the work of a specialist that it engages for a specific purpose or that has been engaged by an issuer's management. In either case, in order for the firm to use the work of the specialist, the firm should, among other things, evaluate the professional qualifications of the specialist to determine whether the specialist possesses the necessary skill or knowledge in the particular field.[29/] The firm also should evaluate the relationship of the specialist to the issuer, including circumstances that might impair the specialist's objectivity.[30/] In addition, the firm should understand the methods and assumptions that the specialist used, make appropriate tests of the data the issuer provided to the specialist, and evaluate whether the specialist's findings support the related assertions in the financial statements.[31/]

Inspection teams identified instances where firms failed to (a) test the data that issuers had provided to the specialists, (b) obtain an understanding of the methods and assumptions that the issuer's specialists had used, (c) evaluate the qualifications or objectivity of the specialist and the relationship of the specialist to the issuer, and (d) evaluate discrepancies between the firm's specialist's conclusions and those of the issuer or the issuer's specialists.

Materiality, Audit Scope, and Audit Differences

The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in

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29/ AU 336, *Using the Work of a Specialist,* paragraph 08

30/ AU 336.10

31/ AU 336.12

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conformity with GAAP, while other matters are not important.[32] Auditors should consider materiality both in (a) planning the audit and designing audit procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with GAAP.[33]

Auditors should consider the effects, individually and in the aggregate, of misstatements that are not corrected by the issuer ("passed adjustments"), and this evaluation should include both quantitative and qualitative considerations. Auditors also should obtain management's representation that it believes the effects of any passed adjustments aggregated by the auditor are immaterial,[34] both individually and in the aggregate, and inform the audit committee about the passed adjustments.[35]

With respect to planning materiality, the inspection teams observed instances where the materiality threshold amounts set by firms did not appear to reflect an appropriate consideration of the factors that could be most important to the users of the financial statements.

The most common deficiency observed by the inspection teams with respect to evaluating the effects of passed adjustments was the failure to accumulate all passed adjustments (other than those amounts that were inconsequential or de minimis) identified during the audit. As a result, some uncorrected misstatements were not communicated to the audit committee or management and were not evaluated in combination with other uncorrected misstatements. Additional deficiencies in this area included the failure to: (a) evaluate, or evaluate sufficiently, the relevant materiality considerations, especially qualitative factors, when considering the effects of passed adjustments on the financial statements; (b) evaluate, or evaluate sufficiently, the effects of identified misstatements on the adequacy of the audit procedures performed; (c) evaluate the effects of known misstatements on prior quarterly and annual financial statements; and (d) quantify identified misstatements in reaching a conclusion that the effects of the misstatements were not significant.

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[32] AU 312*, Audit Risk and Materiality in Conducting an Audit,* paragraph 03

[33] AU 312.12

[34] AU 333, *Management Representations*, paragraph 06

[35] AU 380, *Communication with Audit Committees,* paragraph 10

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General Observations Concerning Auditing Deficiencies

There are a number of potential causes of the deficiencies described above. In many cases, more than one cause may contribute to the occurrence of an auditing deficiency. Deficiencies may stem from weaknesses in training, audit methodology, a firm's monitoring of audit quality and enforcement of its policies and procedures, and the specific quality control areas. As discussed below, in many cases, inadequate supervision and review and failures to apply appropriate professional skepticism were important factors that allowed deficiencies to occur.

Certain deficiencies raised questions about the sufficiency, rigor, and effectiveness of the supervision and review activities of engagement managers and partners, including the thoroughness with which they reviewed audit documentation. In some cases, it appeared that the engagement partners had not devoted sufficient attention to their responsibilities, or their commitment to engagements did not appear to correlate with the risk that the engagements presented. Certain of the deficiencies described above were in areas that required management's most difficult or complex judgments, and thus were in areas where the partners and managers should be devoting significant attention.

In addition, some of the deficiencies were in areas that ordinarily would be reviewed by the concurring review partner. Further, in some instances, the inspection teams observed that the concurring review partner for an audit for which there were deficiencies committed a relatively small amount of time, compared to the firm's overall commitment to the audit. These observations suggest that there may have been weaknesses in the applicable firm's policies and procedures, or the application of them, in this important area.

Certain of the deficiencies also raised concerns about the sufficiency of firms' application of professional skepticism and objectivity in some audits, including some of the larger audits inspected. In some instances, firms did not sufficiently test or challenge management's forecasts, views, or representations that constituted critical support for amounts recorded in the financial statements. In many of these instances, they limited their audit procedures to obtaining management's oral representations.

3. Deficiencies Observed in Reviews of Certain Specific Quality Control Areas

In their review of firms' quality control systems and processes, inspectors also observed deficiencies. The section below highlights some of the areas in which deficiencies were observed, and provides examples of the deficiencies in those areas.

Partner Evaluation and Certain Other Aspects of Firm Structure, Organization, and Management

Inspections of the domestic annually inspected firms have included procedures to assess whether the design and application of the Firm's processes related to partner evaluation and compensation could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the firm. The inspection teams interviewed members of firm leadership regarding these topics. In addition, the inspectors reviewed a sample of the partners' personnel files, including files of partners who had significant negative inspection results from recent internal and PCAOB inspections.

In some instances, inspection teams found various matters that provided cause for concern about firms' partner evaluation and compensation processes. These included situations where audit quality did not appear to be a significant factor in the partner evaluation process or its role in the process was unclear. In some cases, partners received high ratings on technical competence even though there were significant deficiencies in their audits that were reviewed in the firm's internal inspection program or in the PCAOB's inspection program. In addition, inspectors observed situations where concurring review partners or internal inspectors were not held accountable for failing to identify significant deficiencies in audits they reviewed and where partners' quality ratings were affected significantly by the results of client satisfaction surveys or the profitability of their audits or their ability to increase revenues.

For some firms, the PCAOB inspectors noted that technical personnel who were responsible for audit quality were reporting to and evaluated by those whose responsibilities included maintaining and growing the audit practice. This may compromise the objectivity of the technical personnel and may increase the possibility that decisions on technical accounting and auditing matters may be inappropriately influenced by compensation considerations and the firm's desire to grow the size and profitability of its audit practice. In other instances, the technical personnel also had significant client responsibilities that may have led to conflicting priorities and to not having enough time to fulfill their responsibilities for audit quality.

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Internal Inspections

The PCAOB's inspections included a review of aspects of the internal inspection programs that the firms use to review the performance of issuer audits. PCAOB inspection teams typically used two techniques to assess the effectiveness of the firms' internal inspection programs: (a) inspecting an audit after it was inspected in the firm's internal inspection program, and (b) reading and evaluating the detailed findings resulting from internal inspections of individual issuer audits. Through these processes, PCAOB inspection teams sometimes identified audit deficiencies that the firm's internal inspectors had not detected that were of such significance that it appeared to the PCAOB inspection team that the firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements.[36/] In addition, PCAOB inspection teams identified instances where firms' internal inspection reviewers inappropriately categorized audit performance deficiencies as documentation deficiencies based on oral representations from engagement teams when there was not any supporting audit documentation or persuasive other evidence. This raised concerns that those internal inspections may not have been conducted in a sufficiently objective manner.

Foreign Affiliates

In some cases, the scope of an audit includes performing procedures on the financial information regarding the foreign operations of U.S. issuers, and firms typically assign that portion of the audit to foreign firms. Ordinarily, these firms ("foreign affiliates") are members of the global organization to which the U.S. firm belongs. In such cases, the foreign affiliates perform the audit procedures, which should be performed in accordance with PCAOB standards, and the U.S. engagement team is responsible for supervising and controlling such work. Inspection teams' procedures in this area have included inspecting evidence of the supervision and control exercised by the U.S. engagement teams over the work of the foreign affiliates, including the communications between the firm and the foreign affiliates. Inspection teams also have considered how U.S. engagement teams have addressed issues raised by the foreign affiliates.

[36/] These audit deficiencies ordinarily are described in the public portion of the firms' inspection reports.

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In some cases, inspection teams have noted that U.S. engagement partners lacked a sufficient basis for assessing a foreign firm's and the foreign personnel's qualifications and familiarity with U.S. GAAP, PCAOB standards, and SEC reporting requirements. Inspection teams observed instances where firms failed to make available to their engagement partners all relevant internal inspection information available to the firm about the foreign-affiliate firms and personnel whose work those partners use in their audits, and where the U.S. partners did not inquire about the results of the internal inspections of the firms and partners responsible for auditing the foreign operations of the U.S. issuers. In addition, inspection teams noted that, in some cases, minimum levels of training on GAAP, PCAOB standards, or SEC reporting requirements had not been established for the foreign-affiliate personnel participating in the audits of the foreign operations of U.S. issuers.

Inspection teams identified instances where firms failed to appropriately evaluate the results of the work of, or failed to adequately supervise and control the work performed by, their foreign affiliates on the foreign operations of U.S. issuers. The deficiencies included failing to (a) resolve findings or matters identified by the foreign affiliates, and (b) obtain the required information from one or more foreign affiliates.[37/]

Independence

Inspections of the domestic annually inspected firms have included procedures to evaluate the firms' policies and procedures for compliance with the independence requirements applicable to audits of issuers. Inspection teams typically have reviewed firms' policies and procedures, tested compliance with those policies and with independence requirements, reviewed the firms' own monitoring of such compliance, and reviewed information concerning the firms' business ventures, alliances, and arrangements.

In some cases, inspection teams have found deficiencies in firms' independence policies and procedures. These include deficiencies in policies and procedures for monitoring whether business relationships, including joint ventures and alliances entered into with other companies, cause the firm to be in violation of independence restrictions. In some cases, firms did not have procedures to identify and monitor business relationships, or to monitor whether the firm's joint ventures, alliances, or other business relationships were providing prohibited non-audit services to issuer audit

[37/] Auditing Standard No. 3, *Audit Documentation,* paragraph 19 clients. Inspection teams also noted instances where it appeared that firms' foreign affiliates may have been providing non-audit services to the foreign operations of U.S. issuer audit clients in circumstances that would cause the U.S. firm to be in violation of independence restrictions. Some firms lacked formal systems or procedures to monitor the services their foreign affiliates actually performed.

Remediation of Quality Control Criticisms

A firm can keep quality control criticisms nonpublic by addressing the criticisms to the Board's satisfaction within 12 months.[38/] A firm may make a submission, pursuant to PCAOB Rule 4009, concerning the ways in which the firm has addressed the criticisms during the 12 months,[39/] and the Board determines whether the firm has addressed the criticisms satisfactorily for the purposes of Section 104(g)(2) of the Act.

When making a determination as to whether a firm has addressed the criticisms to the Board's satisfaction within the 12-month period, the Board focuses its assessment on whether the firm has identified steps suited to the particular objective, and is, in good faith, making reasonable progress in implementing those steps.[40/] A favorable determination does not necessarily mean that the firm has completely and permanently cured any particular quality control defect. With respect to some types of quality control criticisms, a firm may not, realistically, be able to implement practices and procedures that completely achieve the desired objectives in a 12-month period. It is always possible, however, for a firm to demonstrate that it has begun to address the problem seriously, substantially, and in good faith.

[38/] Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2), states that no portions of an inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.

[39/] See PCAOB Rule 4009(a)

[40/] See PCAOB Release No. 104-2006-077, *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports* (March 21, 2006)

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The Board made favorable determinations on the domestic annually inspected firms' remediation of quality control criticisms contained in the reports on the 2004 and 2005 inspections of the firms.[41/] Many (although by no means all) of the firms' remedial actions with respect to those first two years of inspections, fell within five broad categories of changes. Across the various categories of deficiencies described in this report (as well as with respect to other deficiencies not specifically described in this report), the firms made changes in or additions to (a) policies and procedures, (b) programs and checklists, (c) tools and templates, and (d) audit-related training. In addition, in numerous instances the firms issued releases or other firm-wide communications that emphasized the importance of adhering to or using the revised procedures or tools or emphasized the importance of the areas highlighted in the Board's inspection reports.

While there were, in some instances, similarities in how different firms chose to treat similar defects, each firm chose its own method to remediate the defects. This choice was affected by the nature of the individual deficiencies giving rise to the criticism, as well as by the individual firm's perception of its existing strengths and weaknesses; its structure, resources, and governance characteristics; and the actions that it was taking, or had taken, to remediate other quality control criticisms. For this reason, even in situations where criticisms were similar for different firms, acceptable remediation approaches could be – and were in some cases – different.

The discussion that follows highlights certain areas in which particular firms have taken steps in the first two years of remediation. The actions described below include changes that were intended to address certain of the quality control criticisms highlighted above, as well as in some cases criticisms that are not specifically addressed in this report. The discussion below is neither a comprehensive list of all actions that a single firm has taken, nor a compendium of all actions all firms have taken in a particular area. Rather, it is intended to highlight the breadth and variety of actions that various firms have taken to improve audit performance in response to the contents of Board inspection reports. Accordingly, the Board cautions against interpreting the following discussion as a suggestion of preferred or singularly appropriate ways to remediate a specific quality control defect, or as any indication that any particular domestic annually inspected firm has instituted any of the changes discussed below.

[41/] The remediation process with regard to the 2006 and 2007 inspection reports is occurring during 2008 and 2009.

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Partner Evaluation and Certain Other Aspects of Firm Structure, Organization, and Management

Remediation responses related to partner evaluation and compensation processes have included revisions to the partner evaluation process to place greater, or more explicit, emphasis on audit quality and technical skills. Firms that have taken this step have indicated that these changes are intended to link audit quality with partner compensation or place appropriate and consistent emphasis on quality and professional excellence. In addition, some firms have added specific audit quality goals to their partner evaluation process or have formed task forces to specify metrics for partner evaluation and compensation or develop compensation processes that are intended to ensure that the firm fulfills its professional responsibilities as a public accounting firm.

Some of the firms have made changes to their management structures to provide greater separation between the audit quality function and audit business operations, in an effort to decrease the possibility that decisions on technical accounting and auditing matters may be inappropriately influenced by the economic priorities of the audit practice. In a similar vein, certain of the firms have altered their reporting lines at regional or office levels either to provide that professionals who are responsible for audit quality are subject to oversight by other professionals in that capacity or to revise how the evaluation and compensation decisions for technical personnel are made so that they no longer rest solely with operations leaders but instead are determined with the involvement of other, higher-level technical personnel.

Some firms have created national- or regional-level positions and/or committees to promote and monitor audit quality issues involving (a) training, (b) audit tools and techniques, (c) client acceptance and retention, (d) auditing fair value, (e) archiving, or (f) other professional practice issues.

Auditing Deficiencies

Firms have undertaken various initiatives to examine and adjust their audit methodologies, policies, and procedures. Firms have developed programs or procedures specifically directed to the categories of deficiencies highlighted in inspection reports. For example, firms have (a) instituted a requirement (i) that audit engagement partners must specifically review audit documentation related to areas where the firm has experienced repeat past inspection findings, and/or (ii) that a review in addition to what is required by PCAOB standards of certain of those areas must be completed by someone not otherwise assigned to work on the audit; (b) created subject matter networks or groups for areas of accounting and auditing where there have been deficiencies, such as income taxes; or (c) required industry-specific experience for audit partners, managers, and senior accountants or minimum levels of industry education for audit managers and senior accountants.

Other initiatives include (a) implementing new versions of audit or archiving software that are intended to facilitate the supervision and review of audit work and to improve the consistency and quality of documentation, (b) centralizing the review of service auditors' reports by firm specialists, (c) establishing a relationship with an outside valuation expert to provide services to audit teams nationally, (d) reviewing the work loads of certain quality control professionals, and (e) monitoring the hours spent on issuer audits by information-systems auditors to promote adequate involvement. One firm adopted a new process for calculating audit materiality.

Some firms have made significant efforts to recruit additional audit professionals or to increase the number of quality control personnel, revenue-recognition experts, information-systems auditors, or valuation specialists.

Internal Inspection

Firms have modified their internal inspection programs, including, in some instances, making significant changes to the staffing of the program. These changes include (a) adding additional full-time personnel, (b) increasing the time commitment for part-time reviewers, or (c) moving from a part-time reviewer model to a dedicated group of individuals on full-time assignment. Other changes include (a) adding topic-specific internal inspection reviews for certain areas, such as income taxes; (b) providing for surprise internal inspections; (c) requiring training for internal inspectors on the conduct of internal inspections; (d) increasing the number of audits of issuers inspected each year; (e) selecting more issuer engagements per partner; (f) decreasing the predictability of the engagement selections or changing from a rotation to a risk-based approach; or (g) redesigning their inspection questionnaires to allow for more judgment by the inspectors in selecting areas to review.

Foreign Affiliates

A range of measures have been undertaken to respond to quality control deficiencies identified in this area, including (a) instituting accreditation policies and specific continuing education requirements for non-U.S. professionals who work on the audits of U.S. issuers' foreign locations; (b) establishing a web-based computer system

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to deliver training to, and track participation by, such non-U.S. professionals; (c) establishing processes to obtain the results of internal inspections of non-U.S. professionals who are involved in the audits of U.S. issuers and make them available to relevant U.S. partners; or (d) adding global audit quality positions to help drive a more consistent execution of firm policies and methodologies by member firms.

Independence

Firms have addressed applicable quality control deficiencies related to business relationships by, among other things, (a) establishing a dedicated team to identify and evaluate business relationships in the U.S. and abroad, (b) establishing policies and procedures for entering into business relationships, or (c) monitoring the ongoing activities of business relationships to ensure the activities comply with the independence rules.

In response to quality control deficiencies related to the risk of prohibited services being provided by foreign affiliates, some firms have (a) used the results of independence reviews of foreign affiliates, conducted by a group dedicated to that purpose, to evaluate the services provided; (b) developed independence and compliance systems to assist in obtaining U.S. engagement team and audit committee pre-approval of services to be provided by foreign affiliates; and (c) enhanced their independence conflict-checking procedures for clients with international operations by, in addition to requiring the performance of an independence conflict check of the individuals assigned to the audit and certain others, requiring positive confirmation from member firms located in countries where prospective clients have operations, and negative confirmation from other member firms, that no independence issues exist.

Conclusion

The Board has issued this report to highlight certain areas where its inspectors of the domestic annually inspected firms have identified deficiencies and to describe some of the steps particular firms have implemented in an effort to remediate the deficiencies and improve their audits. The Board will continue to monitor the performance of audits and the adequacy of the quality control systems of these firms so as to achieve its mission of protecting the interests of investors and furthering the public interest in the preparation of informative, fair, and independent audit reports.