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Report on

2017 Inspection of Ernst & Young LLP

(Headquartered in New York, New York)

Issued by the

Public Company Accounting Oversight Board

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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

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2017 INSPECTION OF ERNST & YOUNG LLP

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EXECUTIVE SUMMARY

In 2017, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act"). The inspection procedures included reviews of portions of the Firm's work on 55 issuer audits, which generally related to issuer year ends in 2016.

The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. In 17 audits, certain of these deficiencies 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. These deficiencies are described in Part I.A of the report.

The Board cautions against using the number of audits with deficiencies in the public portion of a report to draw conclusions about the frequency of deficiencies throughout the firm's practice. The audits to be reviewed are most often selected based on perceived risk and not through a process designed to identify a representative sample that could be extrapolated to the firm's entire practice. The portions of these audits that are reviewed often involve the most risky areas of the financial statements. Thus, much of the audit work that is inspected presents, in the inspection team's view, a heightened possibility of auditing deficiencies.

In the 2017 inspection, the inspection team also assessed the Firm's system of quality control related to issuer audits. Pursuant to the Act, any criticisms or discussions of defects or potential defects in that system will remain nonpublic unless the Firm fails to address those criticisms or defects to the Board's satisfaction no later than 12 months after the issuance of this report.

Audit Opinions Affected by the Identified Deficiencies

Fifty-three of the 55 engagements inspected were integrated audits of both internal control and the financial statements. As depicted in the table below, the inspection team identified deficiencies in both financial statement audits and audits of internal control over financial reporting ("ICFR"). In one of the audits described below, after the primary inspection procedures, the Firm revised its opinion on the effectiveness of the issuer's ICFR to express an adverse opinion.

	Number of Audits
Audits for which deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	15 Audits: Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, and O
Audits for which deficiencies included in Part I.A related to the ICFR audit only	1 Audit: Issuer Q
Audits for which deficiencies included in Part I.A related to the financial statement audit only	1 Audit: Issuer P
Total	17

Most Frequently Identified Audit Deficiencies

The following table lists, in summary form, the types of deficiencies that appear most frequently in Part I.A of this report and shows which issuer audits included these deficiencies.

Issue	**Part I.A Audits**
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing	11 Audits: Issuers B, D, E, F, I, J, K, L, M, O, and Q
Failures to sufficiently test controls over or sufficiently test the accuracy and completeness of data or reports	8 Audits: Issuers B, C, D, F, H, I, J, and N
Failure to sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate	6 Audits: Issuers E, F, K, L, M, and P

Areas in which Audit Deficiencies Were Most Frequently Identified

The following table lists, in summary form, the financial statement accounts or auditing areas in which the deficiencies that are included in Part I.A of this report most frequently occurred.

Area	**Part I.A Audits**
Revenue, including accounts receivable	8 Audits: Issuers A, B, C, D, E, F, G, and H
Inventory	6 Audits: Issuers A, B, C, D, F, and H

Area	Part I.A Audits
Business combinations	3 Audits: Issuers E, I, and K
Investments	3 Audits: Issuers N, O, and P

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Inspections are designed and performed to assess compliance with applicable standards and requirements. The inspection team reviews both (1) selected audits and (2) policies and procedures related to quality control processes. The primary procedures[1] for the inspection were performed from October 2016 to August 2018. Inspectors conducted field work at the Firm's National Office and inspected issuer audits performed by 29 of the Firm's approximately 69 U.S. practice offices.

Part I.A includes a description of all audit deficiencies that reach a defined level of significance, which is described below. These deficiencies are categorized in various ways in both Part I.B and the Executive Summary. Part I.C of this report provides certain demographic information about all of the audits inspected. Part I.D provides a general description of the procedures performed in an annual inspection.

Inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control. This focus on deficiencies and defects necessarily carries through to inspection reports and, therefore, the reports are not intended as balanced report cards or overall rating tools. Further, the lack of discussion within a report of an aspect of the inspected firm's quality control system should not be interpreted to imply that the Board has reached a conclusion about that aspect. Similarly, 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, an 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 described in that report.

The inspection team's evaluation of the Firm's quality control system included both (1) a review of certain aspects of the Firm's quality control system and (2) an

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[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.

assessment of whether the deficiencies identified in individual audits indicate defects or potential defects in the Firm's system of quality control.

A. Review of Audit Engagements

The inspection procedures included reviews of portions of 54 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.

Certain of the deficiencies were of such significance that the inspection team determined that the Firm issued an opinion without obtaining sufficient appropriate audit evidence that the financial statements were free of material misstatement and/or the issuer maintained effective ICFR. These deficiencies are described in Part I.A. The descriptions in Part I.A include references to the auditing standards that most directly relate to those deficiencies. (See Appendix C for the text of these standards.) References to provisions of the auditing standards that generally address all aspects of the audit are provided only when lack of compliance with these standards is the primary reason for the deficiency.[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. In many cases, the Firm has since performed remedial actions intended to address the deficiencies.[3] That an audit deficiency reached the level of significance to be included in Part I.A of an inspection report does not mean that the financial statements are misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team to reach a conclusion on those points because the inspection team usually has only the information the auditor retained and the issuer's public disclosures. Even when

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[2] These broadly applicable provisions are described in Part I.B of this report.

[3] 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. An inspection normally includes a review, on a sample basis, 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 could be a basis for criticisms of the firm's quality control system or Board disciplinary sanctions.

not associated with a disclosed misstatement or previously unidentified material weakness, an auditor's failure to obtain sufficient appropriate audit evidence is a serious matter.

The audit deficiencies that were so significant that it appeared that the audit opinion was unsupported are described in Parts I.A.1 through I.A.17, below. Issuer audits are generally presented in the order of significance of the deficiencies identified in the inspections of those audits; severity is assessed based on extent of the deficiencies identified in the audit, financial statement accounts affected, and/or potential consequences of the audit deficiency.

Audit Deficiencies

A.1. Issuer A

In this audit of an issuer in the consumer discretionary industry sector, 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's inventory and revenue processes were highly automated, with inventory and revenue transactions being initiated, processed, and recorded by a number of different information-technology ("IT") systems. The Firm's audit strategy included testing IT general controls ("ITGCs") to support its conclusions about the effectiveness of controls over inventory, revenue, and accounts receivable. These procedures were insufficient. Specifically –

    - The Firm selected one control over the granting of access to all IT systems. The Firm used the work of the issuer's internal audit ("IA") group as evidence about the effectiveness of this control. IA identified exceptions in its testing and concluded that the control was ineffective for all systems. The Firm concluded that these exceptions did not result in a control deficiency but failed to consider that these exceptions were relevant to the other systems subject to this control. (AS 2201.48)

    - The Firm tested one control over the change management process for all IT systems. The Firm failed to sufficiently test this control, as its procedures to test system changes for one inventory IT system that it selected for testing were limited to inquiry of issuer personnel. (AS 2201.42 and .44)

- o The issuer implemented two inventory warehouse management systems during the year. The Firm designed its testing of ITGCs based on the premise that these systems were subject to the same controls as other IT systems. The Firm, however, failed to perform any procedures, beyond inquiry of management, to determine that the ITGCs selected for testing were designed to cover these systems. (AS 2201.42 and .44)

- o The Firm also tested certain controls over access to particular functions within certain revenue and inventory IT systems. In testing these controls, the Firm, however, failed to identify, and evaluate the implications of, certain users' access to certain of these functions that resulted in inappropriate segregation of duties within these systems for these users. Further, for two of these controls, which were related to privileged access to certain of these systems, the Firm's testing was insufficient, as it did not address all of the identified risks associated with access to particular functions within these systems. (AS 2201.42 and .44)

- o The Firm's testing of certain automated and IT-dependent manual controls over inventory, revenue, and accounts receivable was not sufficient. Specifically, these controls used data and reports generated or maintained by the IT systems that were subject to the deficiencies in ITGC testing that are described above, and the Firm did not test any other controls that would have provided assurance about the accuracy and completeness of these data and reports. (AS 2201.46-.47)

- The Firm designed certain of its substantive procedures – including the sample sizes used in those procedures – 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 sample sizes that the Firm used to test inventory, revenue, and accounts receivable were too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

A.2. Issuer B

In this audit of an issuer in the information technology industry sector, 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's testing related to a significant portion of revenue was insufficient, as follows –

    - The Firm selected for testing a control consisting of the review of individual contracts for appropriate revenue recognition; this control was designed to operate with respect to contracts that exceeded a monetary threshold. The Firm's procedures to test this control consisted of (1) inquiring of the control owners, (2) inspecting the two contracts that were reviewed in the performance of this control, and (3) inspecting emails and other documents that indicated reviews and certain other actions performed as part of the control had occurred. The Firm failed to evaluate (1) whether the monetary threshold the control owners used to select contracts for review was appropriate to address the risk of material misstatement related to the recognition of this revenue and (2) the specific nature of the review procedures that the control owners performed to determine the appropriateness of the recognition method for this revenue. (AS 2201.42 and .44)

    - Certain of the issuer's arrangements for this revenue included the delivery of both products and services. The Firm failed to perform any substantive procedures to evaluate whether the issuer recognized revenue from these arrangements in conformity with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Subtopic 605-25, *Multiple-Element Arrangements*. (AS 2810.30)

- The issuer held certain inventory at numerous locations and used two inventory management systems in the performance of its cycle counts of this inventory. Inventory data were transferred between the inventory management systems and the perpetual inventory system in order to identify which items would be counted and to record the cycle-count results. The Firm's procedures to test the existence of, and controls over the existence of, this inventory were not sufficient. Specifically –

  - o The Firm selected for testing four controls over the issuer's cycle counts, which used the inventory data discussed above. The Firm failed to identify and test any controls over the transfer of the data between the inventory management systems and the perpetual inventory system, or otherwise test controls that would have provided assurance over the accuracy and completeness of the data used in the operation of these controls. (AS 2201.39)

  - o One of these four controls consisted of the issuer's daily cycle counts, including the recording of adjustments based on the results of those counts. To test the design and operating effectiveness of this control, the Firm selected a sample of counts for certain locations and observed a small number of these counts. For the remaining counts in the sample, the Firm's procedures consisted of (1) inquiring of issuer personnel, (2) inspecting the issuer's cycle-count instructions, and (3) inspecting documentation related to the performance of the counts and the recording of adjustments resulting from the counts. For these counts in the Firm's sample, however, the Firm failed to evaluate whether the cycle-count documentation it inspected provided evidence that all important steps related to the counts were performed as designed. (AS 2201.44)

  - o Due to the deficiencies described above, the Firm's testing of controls did not provide sufficient evidence, and the Firm did not perform any other procedures to obtain such evidence, that the cycle-count procedures the issuer used for this inventory were sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year. (AS 2510.11)

- The issuer used data and reports that were generated by an IT application in the performance of certain other controls that the Firm tested over the revenue and inventory discussed above. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the data and reports generated by this application that were used in the operation of controls the Firm tested. (AS 2201.39)

A.3. Issuer C

In this audit of an issuer in the industrials industry sector, 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 initiated and processed transactions related to revenue and inventory at numerous locations using various IT systems. The Firm's procedures related to revenue, accounts receivable, and inventory at certain of the issuer's locations were insufficient as described below; the total revenue, accounts receivable, and inventory at these locations were multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement.

    - With respect to these locations, the Firm identified and tested two controls that involved a review element but did not test any controls over the accuracy and completeness of the information used in the performance of these controls. (AS 2201.39)

    - The Firm's procedures to test revenue and accounts receivable for all of these locations, and to test inventory for most of these locations, were limited to testing the issuer's reconciliations of the accounts receivable and inventory sub-ledgers to the general ledger for certain locations. The Firm also performed analytical procedures for all locations, but these analytical procedures were designed to be risk assessment procedures and therefore provided little or no substantive assurance. (AS 2301.08)

- The issuer used an inventory management system in the performance of its cycle counts for the inventory held by one of its subsidiaries, which is not included in the locations noted above. Inventory data were transferred between the inventory management system and the issuer's perpetual inventory system in order to identify which inventory items would be counted and to record the cycle-count results. In addition, the issuer used these inventory data to calculate revenue adjustments related to products that had not shipped and for which recognition of revenue was not appropriate. The Firm identified a fraud risk related to the issuer's recognition of revenue for products that had not shipped. The Firm's procedures related to this inventory and revenue were insufficient. Specifically –

- o The Firm selected for testing various controls, including the issuer's cycle-count controls and the review of the revenue adjustments, that used the inventory data discussed above. The Firm failed to identify and test any controls over the transfer of the data between the inventory management system and the perpetual inventory system, or otherwise test controls that would have provided assurance over the accuracy and completeness of the data used in the operation of these controls. (AS 2201.39)

- o Due to the deficiency described above, the Firm's testing of controls did not provide sufficient evidence, and the Firm did not perform any other procedures to obtain such evidence, that the cycle-count procedures the issuer used for this inventory were sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year. (AS 2510.11)

- o The Firm failed to perform sufficient substantive procedures to test the revenue adjustments discussed above. Specifically, the Firm failed to perform any substantive procedures to test, or (as noted above) sufficiently test controls over, the accuracy and completeness of the inventory data that the Firm used in its testing of the revenue adjustments. (AS 1105.10)

A.4. Issuer D

In this audit of an issuer in the consumer discretionary industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to two types of revenue and certain inventory. Specifically –

- For the first type of revenue, the Firm identified a fraud risk related to revenue cut-off due to the manual nature of the issuer's process to record this revenue. The Firm's procedures with respect to this revenue were insufficient, as follows –

  - o The Firm identified a deficiency in the issuer's controls over certain manual price adjustments for this revenue. In evaluating the severity of the control deficiency, the Firm identified and tested a compensating control that consisted of the review of shipping terms for another type of revenue. The Firm failed to sufficiently evaluate the severity of the control deficiency, as it failed to identify that the compensating control did not address the risks related to this revenue. (AS 2201.68)

- To address the identified fraud risk related to this revenue, the Firm selected for testing two controls that consisted of the reviews of transactions that occurred or were recorded near the end of a period, and that exceeded an established threshold, to determine whether the revenue was recorded in the appropriate period. The Firm failed to sufficiently test the design of these controls. Specifically, the Firm failed to evaluate whether the thresholds and, for one of the controls, the time period that the control owner used to select transactions for review, were sufficiently precise to prevent or detect a material misstatement. (AS 2201.42)

- The issuer's recognition of this revenue was based on quantities and shipment dates provided by certain external parties. The Firm failed to identify and test any controls regarding whether recorded revenue accurately reflected quantities shipped. (AS 2201.39)

- The Firm's substantive procedures to test this revenue consisted of (1) testing revenue cut-off for a sample of transactions, (2) performing analytical procedures, and (3) testing a sample of transactions to determine whether revenue was appropriately recognized throughout the year. These procedures were insufficient in the following respects –

    - The Firm's analytical procedures provided little to no substantive assurance, as the Firm failed to obtain corroboration of management's explanations for differences that the Firm identified for investigation. (AS 2305.21)

    - The Firm reduced its sample size in the second sample described above based on the level of assurance it intended to obtain from the analytical procedures. Due to the deficiencies in the Firm's analytical procedures, the sample size the Firm used to test these transactions was too small to provide sufficient evidence. (AS 2315.19, .23, and .23A)

- The Firm identified a misstatement in the second sample of revenue transactions tested, but failed to project the identified misstatement to the entire population of this revenue. (AS 2810.12)

- The Firm failed to evaluate whether the misstatement it identified should have had an effect on its conclusion about the effectiveness of the issuer's controls over this revenue. (AS 2201.B8)

- The Firm's procedures with respect to the second type of revenue and certain inventory were insufficient, as follows –

  - The issuer recorded transactions using information, which consisted of quantities and shipment dates, obtained from external parties. This information was used in the operation of two controls that the Firm tested over this inventory and revenue. The only control over the data that the Firm tested consisted of a comparison of data in the issuer's system to data in the same system. The Firm failed to identify and test any controls over the transfer of the information from the external parties to the issuer's system or otherwise test controls that addressed the accuracy and completeness of the data that was entered into the system. (AS 2201.39)

  - The Firm failed to sufficiently evaluate the severity of two control deficiencies that it identified with respect to this revenue and inventory, as follows –

    - The first deficiency related to controls over the accuracy of the shipping terms that the issuer used to record this type of revenue. The Firm identified one control that it believed mitigated this deficiency, but it failed to evaluate whether this control, which consisted of a review of a small portion of this revenue that had one particular characteristic, covered all of the risks that the deficient control was intended to address. (AS 2201.68)

    - The second deficiency related to controls over the issuer's process for matching the shipping information provided by one of the external parties to orders and invoices. The Firm identified and tested two compensating controls. The first control consisted of a comparison of the invoice, purchase order, and shipping documentation for a sample of transactions recorded during the first three quarters of the year. The second control included the review of a listing of transactions provided by one of the external parties. The Firm, however, (1) performed no procedures regarding the operation of the first control in the fourth quarter and (2) failed to identify and test any controls over the accuracy and completeness of the transaction listing used in the operation of the second control. (AS 2201.68)

A.5. Issuer E

In this audit of an issuer in the information technology industry sector, 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 arrangements with customers that contained multiple elements. The Firm failed to perform sufficient procedures related to these arrangements in the following respects –

    - The Firm failed to identify and test any controls that addressed whether the selling prices that the issuer used to allocate revenue to the elements in these arrangements were determined in conformity with FASB ASC Subtopic 605-25, *Multiple-Element Arrangements*. (AS 2201.39)

    - The Firm failed to perform sufficient substantive procedures to evaluate whether the selling prices that the issuer used to recognize revenue from multiple-element arrangements were determined in conformity with FASB ASC Subtopic 605-25, as it limited its procedures to reading the issuer's revenue-recognition memorandum. (AS 2810.30)

- During the year, the issuer acquired a business, and it determined the fair value of the acquired intangible assets using forecasted revenue and margins. The Firm failed to perform sufficient procedures related to the valuation of these intangible assets. Specifically –

- o The Firm selected for testing a control that consisted of the review of the forecasted revenue and margins. The Firm failed to sufficiently test this control, as it limited its procedures to (1) inquiring of the control owner; (2) inspecting, and testing the mathematical accuracy of, the model that the issuer used to calculate the forecasted revenue and margins; and (3) reading the issuer's memorandum and, for certain assumptions included in this memorandum, inspecting supporting documentation that indicated reviews performed as part of the control had occurred. The Firm failed to evaluate the nature of the specific review procedures that the control owner performed to assess the reasonableness of certain significant assumptions underlying the forecasted revenue and margins, including the criteria the control owner used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

- o The Firm failed to perform sufficient substantive procedures to evaluate the reasonableness of certain significant assumptions underlying the forecasted revenue and margins. These forecasts assumed significant revenue growth and increased margins for the first four years of the forecast period, and the Firm documented that the issuer planned to implement various strategies to increase the revenue and margins of the acquired business. The Firm's procedures to evaluate the underlying assumptions were limited to (1) inquiring of management; (2) comparing the forecasted revenue and margins, as well as certain historical data used in the issuer's forecast model, to historical data for the acquired business; (3) comparing the actual revenue and margins of the acquired business to the revenue and margins as forecast; and (4) testing the mathematical accuracy of the issuer's forecast model. The Firm's comparison of the forecasted revenue and margins to the acquired business's historical results indicated that there had been a decline in the revenue growth rates, and a wide range in the margins, of the acquired business over the past three years. In addition, the Firm's procedures indicated that the forecasted revenue growth rates and margins for the first four years of the forecast period were significantly higher than the acquired business's average historical revenue growth rates and margins for the past three years. The Firm, however, concluded that the forecasted revenue and margins were reasonable without performing any additional procedures to evaluate the issuer's ability to carry out its planned strategies to achieve these forecasts. (AS 2502.26, .28, .31, and .36)

A.6. Issuer F

In this audit of an issuer in the industrials industry sector, 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's processes with respect to certain inventory and revenue were highly automated, with the inventory and revenue transactions being initiated, processed, and recorded at numerous locations by a number of different IT systems. Inventory data were transferred between certain of these systems in order to (1) record inventory receipts and shipments, (2) record revenue, (3) determine the inventory items to be counted as part of the issuer's daily cycle counts, and (4) record the cycle-count results. The Firm's procedures related to this inventory and revenue were insufficient, as follows –

    - o The Firm selected for testing various controls over this revenue and inventory, including the issuer's cycle-count controls, that used the inventory data discussed above; the Firm also used system-generated reports that contained the inventory data in its testing of the cycle-count controls. The Firm's procedures related to the accuracy and completeness of these data were insufficient, as its procedures were limited to testing one control that addressed the accuracy of the data for only a small portion of this inventory at one point in time during the year. The Firm failed to identify and test any controls over the transfer of the inventory data between the IT systems, or otherwise test controls that would have provided assurance over the accuracy and completeness of the inventory data used in the operation of the revenue and inventory controls that it tested. In addition, the Firm failed to test the accuracy and completeness of the system-generated reports that it used in its testing of the cycle-count controls or, in the alternative, test controls over the data in those reports. (AS 1105.10; AS 2201.39)

    - o Due to the deficiencies described above, the Firm's testing of controls did not provide sufficient evidence, and the Firm did not perform any other procedures to obtain such evidence, that the cycle-count procedures the issuer used for this inventory were sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year. (AS 2510.11)

- The Firm failed to perform sufficient procedures related to the issuer's assessment of the possible impairment of goodwill, as follows –

  - o The Firm selected for testing three controls; an important aspect of these controls was the review of the revenue forecasts the issuer used in its assessment of the possible impairment of goodwill. The Firm, however, failed to sufficiently test this aspect of these controls. Specifically, the Firm's procedures were limited to (1) inquiring of management; (2) attending certain meetings; (3) reading emails and other documents, including board minutes and issuer memoranda, that indicated that reviews and certain other actions performed as part of the controls had occurred; and (4) reperforming a control owner's test of the mathematical accuracy of certain calculations within the revenue forecasts. The Firm failed to evaluate the nature of the review procedures that the control owners performed to assess the reasonableness of the revenue forecasts, including the criteria they used to identify items for follow up and whether those items were appropriately resolved. (AS 2201.42 and .44)

  - o For one of the issuer's reporting units, the Firm failed to perform sufficient substantive procedures to evaluate the reasonableness of the assumptions underlying the revenue forecasts. These forecasts assumed significant revenue growth, and the Firm documented that the issuer had implemented, or planned to implement, various strategies to increase the revenue of this reporting unit. The Firm's procedures to evaluate the revenue growth rates were limited to (1) inquiring of management, (2) comparing the forecasted revenue growth rates to historical growth rates, and (3) testing the mathematical accuracy of the issuer's forecast model. The Firm's comparison indicated that the average forecasted revenue growth rates for the first three years of the forecast period were significantly higher than the average historical revenue growth rates for the past three years. The Firm, however, concluded that the forecasted revenue was reasonable without performing any additional procedures to evaluate the issuer's ability to carry out its strategies to achieve these forecasts. (AS 2502.26, .28, .31, and .36)

A.7. Issuer G

In this audit of an issuer in the health care industry sector, 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's revenue transactions were initiated, processed, and recorded by a number of different IT systems. The Firm's strategy to address the accuracy and completeness of the information generated by these IT systems that was used in the operation of controls over revenue, deferred revenue, and certain accounts receivable included testing ITGCs. The Firm's procedures to test the ITGCs were insufficient. Specifically –
    - o The Firm selected for testing two controls over the removal of terminated users' access to certain of these IT systems. The Firm's testing of these controls was insufficient, as follows –
        - ▪ The Firm used the work of the issuer's IA group as evidence about the effectiveness of the first control. IA identified that the report of terminated users that the control owners used in the performance of this control was not complete. As a result, IA performed an analysis to determine whether any inappropriate transactions had been recorded using the accounts of terminated users; this analysis indicated that the accounts of certain terminated users remained active. In addition, IA's analysis indicated that some of these accounts had been accessed, including two that had been used to record numerous transactions subsequent to the termination of such users, and that management determined that these transactions were appropriate. The Firm concluded that IA's test exceptions constituted a control deficiency, but failed to appropriately evaluate the severity of this deficiency. Specifically, the Firm limited its procedures to considering the results of IA's analysis, without evaluating (1) whether there was a reasonable possibility that the deficiency would result in a misstatement, (2) the magnitude of the

misstatement that might result from the deficiency, and (3) the effect of any compensating controls. (AS 2201.63 and.68)

- The terminated user report described above was also used in the performance of the second control. The Firm, however, failed to evaluate the implications of the control deficiency discussed above on the effectiveness of this control. (AS 2201.62)

o The two selected controls did not address the removal of one type of access for terminated users with respect to certain of these IT systems, and the Firm failed to identify and test any other controls that addressed the risk related to that type of access. (AS 2201.39)

- The Firm failed to perform sufficient substantive procedures to address the risks of material misstatement related to the identified control deficiency discussed above. Specifically, the Firm limited its procedures to (1) re-performing IA's analysis to identify the active accounts of terminated users, (2) inquiring of issuer personnel, and (3) obtaining emails indicating that management had reviewed the transactions in accounts of terminated users that are discussed above. The Firm, however, failed to evaluate the basis for management's determination that such transactions were appropriate. (AS 2301.08)

A.8. <u>Issuer H</u>

In this audit of an issuer in the materials industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to certain inventory and revenue. The issuer maintained information related to units of measure, such as size or weight, (the "measurement information") for two types of products in two IT systems; each system was specific to one type of product. The issuer used the measurement information to record the revenue and inventory related to these products, and both this revenue and this inventory were multiple times the Firm's established level of materiality and presented a reasonable possibility of material misstatement. The Firm's procedures related to the measurement information were insufficient, as follows –

- The issuer used the measurement information in the operation of various controls that the Firm selected for testing. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the measurement information that was entered into these IT systems. In addition, the Firm failed to identify and test any controls over the transfer of data from the IT system used to record the measurement information for one of these products to the general ledger, or otherwise test controls that would have provided assurance over the accuracy and completeness of the data used in the operation of the revenue and inventory controls that it tested. (AS 2201.39)

- The Firm used the measurement information in its substantive testing of the revenue and inventory related to these products but failed to perform any procedures to test, or, in the alternative, identify and test any controls over, the accuracy and completeness of this information, as noted above. (AS 1105.10)

A.9. Issuer I

In this audit of an issuer in the health care industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. During the year, the issuer acquired a business and engaged external specialists to determine the fair value of the acquired property and intangible assets; the external specialists used information provided by the issuer, including historical earnings data and forecasted revenues and cash flows, to determine these fair values. The Firm failed to perform sufficient procedures related to the valuation of the acquired property and intangible assets. Specifically –

- The Firm selected for testing a control that included the review of the significant assumptions that the issuer used to determine the fair value of the acquired property and intangible assets. The Firm failed to sufficiently test this aspect of the control, as its procedures were limited to (1) inquiring of issuer personnel and (2) inspecting documents that included signatures or other notations that indicated reviews performed as part of the control had occurred. The Firm failed to evaluate the nature of the review procedures that the control owners performed, including the criteria the control owners used to identify matters for follow up and whether those matters were appropriately resolved. In addition, the Firm failed to test the aspects of this control, or test any other controls, that addressed (1) the accuracy and completeness of the historical earnings data that were a significant input to the valuation of the acquired property and (2) the appropriateness of the forecasted revenues and cash flows that were significant inputs to the valuation of the acquired intangible assets. (AS 2201.42 and .44)

- The Firm failed to perform sufficient substantive procedures to test the fair value of the acquired property, as it failed to test the accuracy and completeness of the historical earnings data that the issuer provided to the external specialist. (AS 1210.12)

A.10. Issuer J

In this audit of an issuer in the consumer discretionary industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to two types of rebates that the issuer received from its vendors, one of which was based on purchases by the issuer and the other of which was based on sales by the issuer. Specifically –

- The Firm selected for testing four controls over the first type of rebate. The Firm's procedures were insufficient in the following respects –

    - One of the controls consisted of the review of the calculation of the accrual and the underlying assumptions. The Firm's procedures to test this control were limited to obtaining, and testing the mathematical accuracy of, the calculation of the accrual and inspecting signatures and emails as evidence that reviews had occurred. The Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria used to identify matters for follow up and whether those matters were appropriately resolved. In addition, the Firm failed to identify and test any controls over the completeness of certain data used in the performance of this control. (AS 2201.39, .42, and .44)

    - The Firm identified deficiencies in the remaining three controls over these rebates. The Firm identified and tested three additional controls that it believed would compensate for these control deficiencies. The Firm, however, failed to sufficiently evaluate these compensating controls, as follows –

        - The Firm's procedures to test one of these compensating controls, which consisted of the review of the issuer's income statement and balance sheet, were limited to inspecting documents used in the performance of the control and inspecting emails as evidence that reviews had occurred. The Firm failed to ascertain and evaluate the nature of the review procedures that the control owners performed, including the criteria used to identify items for follow up and whether those items were appropriately resolved. (AS 2201.68)

        - The Firm failed to evaluate whether the remaining two compensating controls, one of which consisted of the review of balance sheet account reconciliations and the other of which consisted of a review of a small portion of these rebates, covered the risks intended to be addressed by the deficient controls. (AS 2201.68)

- The issuer calculated the second type of rebate using certain sales information. The Firm failed to identify and test any controls over the accuracy and completeness of this sales information. (AS 2201.39)

- The Firm's substantive procedures to test the rebate amounts were limited to performing analytical procedures. For these procedures, the Firm calculated the ratio of both types of rebates, in aggregate, to (1) total sales and (2) total purchases and compared these to the same ratios for the prior year, increased by ten percent. The analytical procedures that the Firm performed provided little to no substantive assurance, as described below. (AS 2305.13 and .14)

    - The Firm aggregated both types of rebates when performing its analytical procedures; therefore, these procedures were not precise enough to identify misstatements that could be material.

    - The Firm failed to establish appropriate expectations, as it based its expectations on prior-year ratios adjusted by ten percent, without obtaining evidence, other than through inquiry of management, as to why these adjusted prior-year ratios would be predictive of the current-year results.

A.11. Issuer K

In this audit of an issuer in the industrials industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. During the year, the issuer acquired a business, and it determined the fair value of three acquired intangible assets using revenue forecasts and the fair value of a fourth acquired intangible asset using other significant assumptions. The Firm failed to perform sufficient procedures related to the valuation of these acquired intangible assets, as follows –

- The Firm selected for testing two controls that included reviews of the revenue forecasts and other significant assumptions used in the valuation of these acquired intangible assets. The Firm failed to sufficiently test the aspects of these controls related to the review of these assumptions, as the Firm limited its procedures to (1) inquiring of issuer personnel, (2) observing a meeting between one of the control owners and the issuer's valuation specialist, and (3) inspecting meeting notes and other documents that indicated reviews and certain other actions performed as part of the controls had occurred. The Firm failed to evaluate the nature of the review procedures that the control owners performed, including the criteria the control owners used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

- The Firm failed to perform sufficient substantive procedures to test the valuation of these acquired intangible assets, as follows –

    - The Firm failed to sufficiently evaluate the reasonableness of the assumptions underlying the revenue forecasts used in the valuation of three of the acquired intangible assets. Specifically, the Firm's procedures to test these assumptions included (1) comparing the historical revenue growth rates for the acquired business to historical revenue growth rates for the issuer and certain market participants and (2) inspecting board minutes and due diligence reports related to the acquired business. The Firm concluded that the issuer's revenue forecasts were reasonable without performing any additional procedures to evaluate whether significant underlying assumptions, including the anticipated synergies, were supported. In addition, the Firm observed that the actual current-year revenue growth rate was one percent, as compared to the issuer's projection of ten percent, and that several months after the acquisition, the issuer was expecting that the anticipated synergies would be delayed. The Firm, however, did not take these observations into account when evaluating the reasonableness of the projected revenue. (AS 2502.26, .28, .31, and .36; AS 2810.03)

  - o The Firm failed to perform sufficient procedures to evaluate the reasonableness of the significant assumptions used in the valuation of the fourth acquired intangible asset, as the Firm limited its procedures to inquiry of management. (AS 2502.26 and .28)

A.12. Issuer L

In this audit of an oil and gas company in the energy industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to the valuation of the asset retirement obligations ("AROs"). Specifically –

- The Firm selected for testing a control that included the review of the estimated costs that the issuer expected to incur to fulfill its obligations, which were a significant assumption used in determining the AROs. The Firm's procedures to test this control were limited to (1) inquiring of issuer personnel; (2) inspecting documents with signatures or other notations that indicated reviews performed as part of the control had occurred; (3) verifying that an error in the analysis of the AROs that was prepared as part of the control, which was identified through a control owner's review, was corrected in the final version of the analysis; and (4) reading the issuer's explanations for certain estimated costs. The Firm failed to evaluate the nature of the specific review procedures that the control owners performed to assess the reasonableness of the estimated costs. (AS 2201.42 and .44)

- The Firm failed to perform sufficient substantive procedures to evaluate the estimated costs that the issuer used in determining the AROs. Specifically, the Firm's procedures consisted of (1) comparing the current-year ARO to the prior-year ARO on a field-by-field basis, (2) comparing the estimated costs for wells in certain fields to the actual costs incurred to date for certain wells in these fields, (3) inquiring of management regarding differences identified in these comparisons that exceeded certain thresholds, and (4) reading issuer-prepared cost reports to obtain corroboration of management's explanations for certain of these differences. The Firm, however, failed to test the accuracy and completeness of these cost reports. In addition, the monetary threshold that the Firm used to determine which differences between the actual and estimated costs for individual wells to investigate was, for certain of the fields the Firm selected for testing, higher than the total estimated costs per well. This threshold would have allowed significant differences that could aggregate to a material amount to remain uninvestigated. (AS 2501.11)

A.13. Issuer M

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, as it failed to perform sufficient procedures related to the issuer's accounting for sale-leaseback transactions that the issuer entered into during the year. Specifically –

- The issuer used the estimated fair values of the properties involved in these transactions in its assessment of whether the transactions qualified for sale-leaseback accounting and the classification of the resulting leases. The Firm selected for testing two controls that included reviews of the significant assumptions used in the valuation of these properties. The Firm failed to sufficiently test this aspect of these controls. Specifically, the Firm limited its procedures to inquiring of issuer personnel and inspecting issuer accounting memoranda and valuation reports prepared by the issuer's specialist. The Firm failed to evaluate the nature of the procedures that the control owners performed to review the assumptions underlying the valuation of the properties, including the criteria used to identify matters for follow up and whether those matters were appropriately resolved. (AS 2201.42 and .44)

- The Firm failed to perform sufficient substantive procedures to test the valuation of each of the two types of property involved in the sale-leaseback transactions, as follows –

  - For one type of property, the Firm's procedures to test the issuer's fair values were limited to (1) reading the valuation reports prepared by the issuer's specialist; (2) comparing the estimated fair values in the valuation reports to the sale price for the relevant sale-leaseback transaction; and (3) testing the fair value of one element of the property, which constituted only a small portion of this property type's total fair value. The Firm failed to evaluate the reasonableness of the significant assumptions that the issuer used to determine the fair value of the other element of the property. (AS 2502.26, .28, .31, and .36)

- o For the other type of property, the Firm planned to test the fair value by selecting a sample of these properties to test the reasonableness of the significant assumptions used by the issuer. The Firm, however, failed to evaluate the reasonableness of one of these significant assumptions for the majority of the properties in its sample. (AS 2315.25)

A.14. <u>Issuer N</u>

In this audit of an issuer in the financials industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to the valuation of the issuer's investments. The issuer determined the fair value of the majority of its investments based on valuation models that used the financial information of the underlying investee companies as a significant input. The Firm's procedures related to the financial information were insufficient, as follows –

- The Firm selected for testing three controls that consisted of reviews of the fair values of these investments. The Firm, however, failed to identify and test any specific steps that the control owners performed to address the accuracy and completeness of the financial information of the investee companies, or, in the alternative, test any other controls over the accuracy and completeness of this information. (AS 2201.42 and .44)

- The Firm's substantive procedures to test the accuracy and completeness of the financial information consisted of performing tests of details for two separate samples from the population of investee companies. The first sample was selected based on certain characteristics of the investee companies. The second sample was intended to cover the remainder of the population, which constituted the majority of these investments, and was determined, in part, using a controls reliance approach. The Firm's procedures were insufficient, as the level of control reliance that the Firm used to determine the size of the second sample was not supported due to the deficiency in the Firm's testing of controls that is discussed above.

As a result, this sample was too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

A.15. Issuer O

In this audit of an issuer in the financials industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR, as it failed to perform sufficient procedures related to the valuation of the available-for-sale ("AFS") and held-to-maturity ("HTM") securities. Specifically –

- The issuer recorded the fair values for the AFS and HTM securities based on the prices it received from an external pricing service. The issuer performed a control that consisted of (1) for all securities exceeding one monetary threshold and for a sample of the securities exceeding a lower monetary threshold, the comparison of the recorded fair values to prices obtained from another pricing service and (2) the analysis of any pricing differences identified that exceeded a threshold. The securities that had recorded fair values less than the monetary thresholds and were therefore excluded from this price comparison represented a significant portion of the recorded balance; were, in aggregate, multiple times the Firm's level of materiality; and presented a reasonable possibility of material misstatement. To address the valuation of the AFS and HTM securities, the Firm selected for testing only this control. The Firm, however, failed to sufficiently test whether this control was designed effectively to detect misstatements that could be material, as it did not evaluate whether the monetary thresholds the issuer used for selecting securities for the price comparison, which resulted in a significant portion of securities being excluded from this control, were appropriate to address the risk related to these securities. (AS 2201.42)

- The Firm designed certain of its substantive procedures – including the sample sizes used in those procedures – based on a level of control reliance that was not supported due to the deficiency in the Firm's testing of the control that is discussed above. As a result, the sample sizes the Firm used to test the valuation of AFS and HTM securities were too small to provide sufficient evidence. (AS 2301.16, .18, and .37; AS 2315.19, .23, and .23A)

A.16. Issuer P

In this audit of an issuer in the financials industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements. The issuer recorded the fair values for certain financial instruments without readily determinable fair values based on the prices it received from external pricing services. To test these values, the Firm selected a sample of the financial instruments at an interim date three months before year end and compared the issuer's prices to (1) prices from transactions involving the financial instruments that were within one month of the interim date and/or (2) prices the Firm obtained from pricing services. At year end, the Firm determined that it needed to test a larger sample of these financial instruments. After determining that the majority of the financial instruments that it tested as of the interim date remained in the issuer's portfolio at year end, the Firm selected additional financial instruments for testing and compared the issuer's prices for these additional financial instruments to prices the Firm obtained from pricing services. The Firm also compared the issuer's prices for a sample of the financial instruments at the interim date and at year end to prices obtained from the issuer's pricing services. The Firm's procedures to test the valuation of, and disclosures related to, these financial instruments were insufficient in the following respects –

- The Firm failed to evaluate whether the transaction prices it used in its interim testing reflected circumstances that existed as of the interim date. (AS 2502.40)

- The Firm failed to obtain an understanding of the specific methods and assumptions underlying the fair value measurements it obtained from its pricing services and used in its interim and year-end testing. (AS 2502.40)

- The Firm failed to perform sufficient procedures to test, as of year end, the valuation of the financial instruments that were tested as of the interim date, as the Firm's procedures were limited to (1) verifying that these financial instruments were included in the population of financial instruments held at year end and (2) comparing the recorded values of these financial instruments as of the interim date to the recorded values at year end and, for differences that exceeded certain thresholds, comparing the issuer's year-end prices to prices obtained from the issuer's pricing services. These procedures were insufficient, as the Firm failed to obtain an understanding of the specific methods and assumptions underlying the fair value measurements it obtained from the issuer's pricing services and used in this testing. (AS 2502.40)

- The Firm failed to perform sufficient procedures to test the disclosure of these financial instruments within the fair value hierarchy as set forth in FASB ASC Topic 820, *Fair Value Measurement*, as it failed to obtain an understanding of whether the significant inputs used to establish the fair value of these financial instruments were observable or unobservable. (AS 2502.43)

A.17. Issuer Q

In this audit of an issuer in the energy industry sector, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as it failed to perform sufficient procedures to test controls over the valuation of the issuer's federal deferred tax assets. The Firm selected for testing a control that consisted of the review of an analysis of federal deferred tax assets. The Firm's procedures to test this control were limited to (1) inquiring of the preparer of the analysis and the control owner, (2) vouching certain amounts from this analysis to supporting documentation, and (3) inspecting signatures or other notations that indicated that reviews performed as part of the control had occurred. The Firm failed to evaluate the nature of the specific review procedures that the control owner performed to assess the valuation of the federal deferred tax assets. (AS 2201.42 and .44)

B. Auditing Standards

Each deficiency described in Part I.A above could relate to several provisions of the auditing standards that govern the conduct of audits. The paragraphs of the standards that are cited in Part I.A for each deficiency are only those that most directly relate to the deficiency. The deficiencies also may 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. Paragraphs .02, .05, and .06 of AS 1015, *Due Professional Care in the Performance of Work*, require the independent auditor to plan and perform his or her work with due professional care and set forth aspects of that requirement. AS 1015.07-.09, and paragraph .07 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, 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 2301.03, .05, and .08 require the auditor to design and implement audit responses that address the risks of material misstatement. Paragraph .04 of AS 1105, *Audit Evidence*, 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. Appropriateness is the measure of the quality of audit evidence; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

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 References per Audit
AS 1105, *Audit Evidence*	Issuer C Issuer F Issuer H	1 1 1
AS 1210, *Using the Work of a Specialist*	Issuer I	1
AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	Issuer A Issuer B Issuer C Issuer D Issuer E Issuer F Issuer G Issuer H Issuer I	5 4 2 7 2 2 3 1 1

PCAOB Auditing Standards	Audits	Number of References per Audit
	Issuer J Issuer K Issuer L Issuer M Issuer N Issuer O Issuer Q	4 1 1 1 1 1 1
AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer A Issuer C Issuer G Issuer N Issuer O	1 1 1 1 1
AS 2305, *Substantive Analytical Procedures*	Issuer D Issuer J	1 1
AS 2315, *Audit Sampling*	Issuer A Issuer D Issuer M Issuer N Issuer O	1 1 1 1 1
AS 2501, *Auditing Accounting Estimates*	Issuer L	1
AS 2502, *Auditing Fair Value Measurements and Disclosures*	Issuer E Issuer F Issuer K Issuer M Issuer P	1 1 2 1 4
AS 2510, *Auditing Inventories*	Issuer B Issuer C Issuer F	1 1 1
AS 2810, *Evaluating Audit Results*	Issuer B	1

PCAOB Auditing Standards	Audits	Number of References per Audit
	Issuer D Issuer E Issuer K	1 1 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 the deficiencies 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. The following standards were cited for only one issuer and are excluded from the table: AS 1210 and AS 2501.[4]

	AS 1105	AS 2201	AS 2301	AS 2305	AS 2315	AS 2502	AS 2510	AS 2810
Asset retirement obligations		L						
Business combinations		E, I, K				E, K		K
Impairment of goodwill		F				F		
Income taxes		Q						
Inventory	C, F, H	A, B, C, D, F, H	A, C		A		B, C, F	
Investment securities		N, O	N, O		N, O	P		

[4] The AS 1210 issue for issuer I related to business combinations. The AS 2501 issue for issuer L related to asset retirement obligations.

	AS 1105	AS 2201	AS 2301	AS 2305	AS 2315	AS 2502	AS 2510	AS 2810
Rebates		J		J				
Revenue, including accounts receivable	C, F, H	A, B, C, D, E, F, G, H	A, C, G	D	A, D			B, D, E
Sale-leaseback transactions		M			M	M		

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 and cross references the issuers to the specific auditing standards related to the deficiencies.

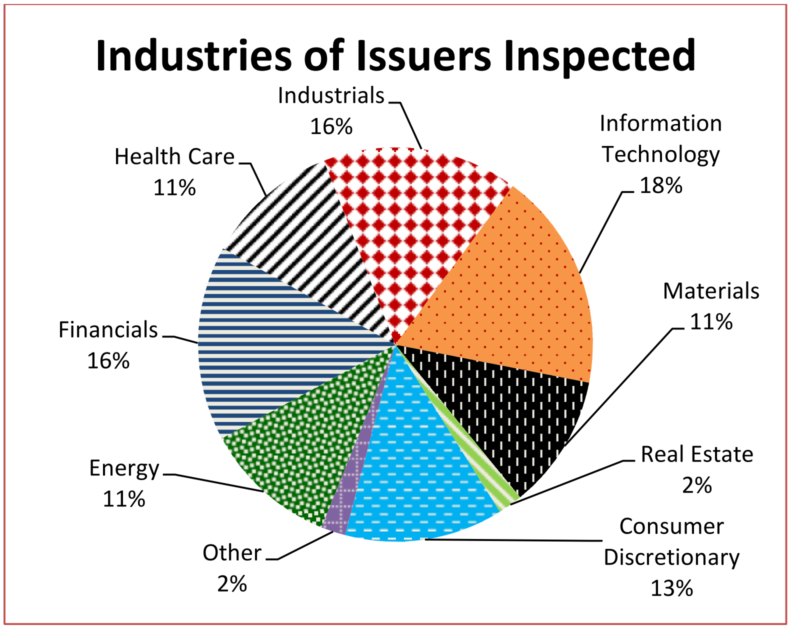
	AS 1105	AS 1210	AS 2201	AS 2301	AS 2305	AS 2315	AS 2501	AS 2502	AS 2510	AS 2810
Consumer Discretionary			A, D, J	A	D, J	A, D				D
Energy			L, Q				L			
Financials			N, O	N, O		N, O		P		
Health Care		I	G, I	G						
Industrials	C, F		C, F, K	C				F, K	C, F	K
Information Technology			B, E					E	B	B, E
Materials	H		H							
Other			M			M		M		

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.

C. Data Related to the Issuer Audits Selected for Inspection[6]

C.1. Industries of Issuers Inspected

The chart below categorizes the 55 issuers whose audits were inspected in 2017, based on the issuer's industry.[7]



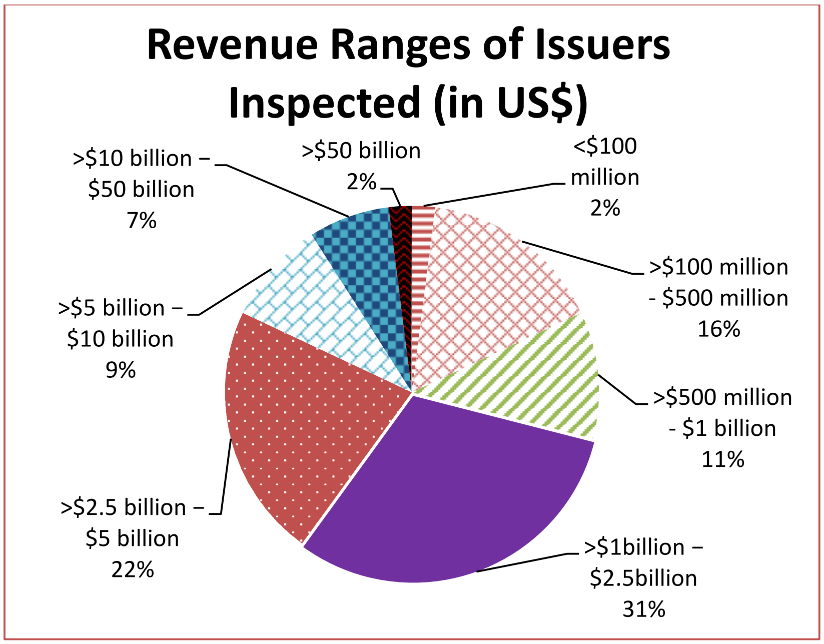
Industry	Number of Audits Inspected	Percentage
Consumer Discretionary	7	13%
Energy	6	11%
Financials	9	16%
Health Care	6	11%
Industrials	9	16%
Information Technology	10	18%
Materials	6	11%
Real Estate	1	2%
Other	1	2%
Total	55	100%

6 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 54 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.

7 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 55 issuers whose audits were inspected in 2017.[8] This presentation of revenue data is intended to provide information related to the size of issuers whose audits 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	1	2%
100-500 million	9	16%
500 million -1 billion	6	11%
1-2.5 billion	17	31%
2.5-5 billion	12	22%
5-10 billion	5	9%
10-50 billion	4	7%
>50 billion	1	2%
Total	55	100%

[8] 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

This section provides a brief description of the procedures that are often performed in annual inspections of auditing firms.

D.1. Reviews of Audit Work

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. For each specific portion of the audit that is selected, the inspection team 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 review of any 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. 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.[9]

Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including

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[9] 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 adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

failures to comply with disclosure requirements,[10] as well as a firm's failure to perform, or to perform sufficiently, certain necessary risk assessment procedures, tests of controls, and substantive audit procedures.

In reaching its conclusions about whether a deficiency exists, 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 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 1215, *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 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.

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,

[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.

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 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.[11] 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;[12] 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

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[11] 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.

[12] 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.

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 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 firm personnel, including firm leadership, and review significant management reports, communications, 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 of material misstatement 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 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 processes 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 and operation of the firm's internal inspection program, and may compare the results of its review 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.[13]

[13] 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 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.

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Mr. George Botic
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

August 19, 2019

Re: Response to Part I of the Draft Report on the 2017 Inspection of Ernst & Young LLP

Dear Mr. Botic:

Ernst & Young LLP is pleased to provide its response to Part I of the Public Company Accounting Oversight Board's (the "PCAOB") Draft Report on the 2017 Inspection of Ernst & Young LLP (the "Report"). The PCAOB has played an important role in strengthening audit quality since its formation in 2002. Through the inspection process, the PCAOB continues to help us and the profession identify areas for further attention and enhance our system of quality controls. We respect and benefit from this process as it aids us in fulfilling our responsibilities to investors, other stakeholders and the capital markets in general.

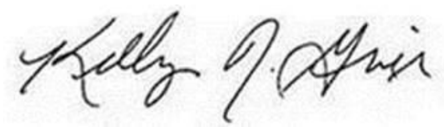
We have thoroughly evaluated the matters described in Part I of the Report and have taken appropriate actions to address the findings in accordance with AS 2901, *Considerations of Omitted Procedures After the Report Date*, and AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Performing high quality audits with independence, integrity and professional skepticism is at the heart of our responsibility as auditors. Our objectives include continuously improving the quality of our audits. To accomplish this, we are creating a truly digital audit that enhances audit quality to lead in a transformative age in which technology is reshaping every aspect of business. We are also simplifying our processes to enable our audit teams to focus on what matters the most, as well as building a workforce of the future by investing in attracting, training, engaging and retaining our audit professionals. We have also formed an Independent Audit Quality Committee ("IAQC"), comprised of seasoned external leaders with extensive, diverse and highly relevant experiences, that are advising our senior leadership on the many aspects of the Firm's business, operations, culture, talent, governance and risk management that affect audit quality. We believe that gaining insight and advice from the IAQC will help us fulfill our important role of delivering high-quality audits that build confidence in the U.S. and global capital markets.

Interested stakeholders can find more information about our efforts to maintain and continuously improve audit quality in our 2018 audit quality report, *Our commitment to audit quality*, located at the following link (https://www.ey.com/en_us/assurance/our-commitment-to-audit-quality-ernst-and-young-llp-2018-report).

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

Respectfully submitted,



Kelly J. Grier
US Chairman and Managing Partner and Americas Managing Partner

John L. King
Americas Vice Chair - Assurance Services

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 1105, *Audit Evidence*		
SUFFICIENT APPROPRIATE AUDIT EVIDENCE		
Using Information Produced by the Company		
AS 1105.10	When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[3] ▪ Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and ▪ Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.	Issuers C, F, and H
Footnote to AS 1105.10 [3] When using the work of a specialist engaged or employed by management, see AS 1210, *Using the Work of a Specialist*. When using information produced by a service organization or a service auditor's report as audit evidence, see AS 2601, *Consideration of an Entity's Use of a Service Organization*, and for integrated audits, see AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.		

AS 1210, *Using the Work of a Specialist*		
Using the Findings of the Specialist		
AS 1210.12	The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (a) obtain an understanding of the methods and	Issuer I

AS 1210, *Using the Work of a Specialist*		
	assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.	

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
USING A TOP-DOWN APPROACH		
Selecting Controls to Test		
AS 2201.39	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 B, C, D, E, F, G, H, and J
TESTING CONTROLS		
Testing Design Effectiveness		
AS 2201.42	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 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.	Issuers A, B, D, E, F, I, J, K, L, M, N, O, and Q

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
Testing Operating Effectiveness		
AS 2201.44	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, E, F, I, J, K, L, M, N, and Q
Relationship of Risk to the Evidence to be Obtained		
AS 2201.46	For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases. Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.	Issuer A

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
AS 2201.47	Factors that affect the risk associated with a control include – ▪ The nature and materiality of misstatements that the control is intended to prevent or detect; ▪ The inherent risk associated with the related account(s) and assertion(s); ▪ Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness; ▪ Whether the account has a history of errors; ▪ The effectiveness of entity-level controls, especially controls that monitor other controls; ▪ The nature of the control and the frequency with which it operates; ▪ The degree to which the control relies on the effectiveness of other controls (*e.g.*, the control environment or information technology general controls); ▪ The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance; ▪ Whether the control relies on performance by an individual or is automated (*i.e.*, an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.	Issuer A

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	▪ The complexity of the control and the significance of the judgments that must be made in connection with its operation. Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively	
AS 2201.48	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 A
EVALUATING IDENTIFIED DEFICIENCIES		
AS 2201.62	The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.	Issuer G
AS 2201.63	The severity of a deficiency depends on – ▪ Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and The magnitude of the potential misstatement resulting from the deficiency or deficiencies.	Issuer G
AS 2201.68	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 D, G, and J

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
APPENDIX B - Special Topics		
INTEGRATION OF AUDITS		
AS 2201.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. ▪ 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.	Issuer D

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*		
RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF AUDIT PROCEDURES		
AS 2301.08	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 C and G
TESTING CONTROLS		
Testing Controls in an Audit of Financial Statements		
AS 2301.16	*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	Issuers A, N, and O

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*		
	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.	
Footnotes to AS 2301.16 [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 2301.18	*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 A, N, and O
SUBSTANTIVE PROCEDURES		
AS 2301.37	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 A, N, and O

AS 2305, *Substantive Analytical Procedures*		
Plausibility and Predictability of the Relationship		
AS 2305.13	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 J
AS 2305.14	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 J
Investigation and Evaluation of Significant Differences		
AS 2305.21	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 differencesmay indicate an increased risk of material misstatement. (*See* AS 2810.)	Issuer D

AS 2315, *Audit Sampling*		
SAMPLING IN SUBSTANTIVE TESTS OF DETAILS		
Planning Samples		
AS 2315.19	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.[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 A, D, N, and O
Footnote to AS 2315.19 [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.		
AS 2315.23	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 the population, including the expected size and frequency of misstatements.	Issuers A, D, N, and O

AS 2315, *Audit Sampling*		
AS 2315.23A	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 A, D, N, and O
Performance and Evaluation		
AS 2315.25	Auditing procedures that are appropriate to the particular audit objective should be applied to each sample item. In some circumstances the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, supporting documentation may be missing. The auditor's treatment of unexamined items will depend on their effect on his evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative procedures that would provide him with sufficient evidence to form a conclusion. The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.	Issuer M

AS 2501, *Auditing Accounting Estimates*		
EVALUATING REASONABLENESS		
AS 2501.11	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 (AS 1210,*Using the Work of a Specialist*). *i.* Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.	Issuer L

AS 2502, *Auditing Fair Value Measurements and Disclosures*		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AS 2502.26	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 audit 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.	Issuers E, F, K, and M
AS 2502.28	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.	Issuers E, F, K, and M
AS 2502.31	Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.	Issuers E, F, K, and M
AS 2502.36	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),[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	Issuers E, F, K, and M

AS 2502, *Auditing Fair Value Measurements and Disclosures*		
	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 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 AS 2502.36 [5] The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).		
Developing Independent Fair Value Estimates for Corroborative Purposes		
AS 2502.40	The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement.[6] When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs .28 to .37. Instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate. The auditor also should test the data used to develop the fair value measurements and disclosures as discussed in paragraph .39.	Issuer P

AS 2502, *Auditing Fair Value Measurements and Disclosures*		
Footnote to AS 2502.40 6 *See* AS 2305, *Substantive Analytical Procedures*.		
Disclosures About Fair Values		
AS 2502.43	The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.[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 P
Footnote to AS 2502.43 8 *See* also paragraph .31 of AS 2810, *Evaluating Audit Results*.		

AS 2510, *Auditing Inventories*		
INVENTORIES		
AS 2510.11	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.	Issuers B, C, and F

AS 2810, *Evaluating Audit Results*		
Evaluating the Results of the Audit of Financial Statements		
AS 2810.03	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 K
AS 2810.12	The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph .13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AS 2315, *Audit Sampling.*[5]	Issuer D
<u>Footnote to AS 2810.12</u> 5 AS 2315.26.		
AS 2810.30	The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Note: AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles*," establishes requirements for evaluating the presentation of the financial statements. AS 2820, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements. Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.	Issuers B and E