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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of KPMG LLP's Quality Control Remediation Submissions	PCAOB Release No. 104-2019-003 January 25, 2019

I.

The Public Company Accounting Oversight Board ("Board" or "PCAOB") has evaluated the submissions of KPMG LLP ("Firm") pursuant to PCAOB Rule 4009(a) for the remediation periods ended October 15, 2016 and November 9, 2017 concerning the Firm's efforts to address certain quality control criticisms included in the nonpublic portions of the Board's October 15, 2015 and November 9, 2016 inspection reports on the Firm ("Reports"). The Board has determined that as of October 15, 2016 and November 9, 2017, respectively, the Firm had not addressed certain criticisms in the Reports to the Board's satisfaction. Accordingly, pursuant to Section 104(g)(2) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 4009(d), the Board is making public the portions of the Reports that deal with those criticisms.[1]

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

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

II.

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

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

ISSUED BY THE BOARD.

/s/ Phoebe Brown

Phoebe W. Brown
Secretary

January 25, 2019

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Statement of KPMG LLP on the PCAOB's January 25, 2019 Release No. 104-2019-003

Nothing is more important to KPMG LLP than fulfilling our critical role in the capital markets by performing high-quality audits and consistently executing on our responsibilities to audit committees and investors. We recognize and support the Public Company Accounting Oversight Board's ("PCAOB") mission of promoting high quality auditing, and we are committed to resolving the concerns identified in the PCAOB's inspection reports. We appreciate the professionalism and commitment of the PCAOB and its staff, and value the important role the PCAOB plays in improving audit quality at our firm and across the profession.

The PCAOB has made public portions of Part II of its Reports on the 2014 and 2015 Inspections of KPMG LLP (the "Reports") because the PCAOB determined that the firm had not satisfactorily addressed the quality control criticisms within the 12-month period after the publication of the Reports. We agree with the PCAOB's determination.

We take seriously our failure to timely address these criticisms. Notably, during a significant portion of the applicable periods, remediation efforts were being led by individuals who engaged in conduct that undermined the integrity of the regulatory process through their inappropriate use of PCAOB confidential information. The conduct of these individuals was contrary to the firm's Code of Conduct, what we expect and demand of our people, and intolerable. Upon learning of such conduct through an internal source in February 2017, the firm took immediate remedial actions that clearly demonstrated the firm's commitment to professional integrity, audit quality and the regulatory process. We immediately informed the PCAOB and the Securities and Exchange Commission ("SEC") and opened an investigation conducted by outside counsel. Since then, when information came to the firm's attention that indicated that individuals, including those responsible for leading the Audit practice at the time, had engaged in conduct contrary to both the letter and the spirit of the regulatory process, our Code of Conduct, or the firm's system of internal controls, the firm took appropriate remedial action, including separating responsible individuals from the firm.

Over the last 18 months, we have made significant changes to our audit leadership team, including the appointment of a new Vice Chair-Audit, a new National Managing Partner-Audit Quality and Professional Practice, a new National Managing Partner of Audit Operations, a new Chief Auditor, and a new Inspections Leader. All were chosen for their roles, first and foremost, because of their demonstrated record of sound judgment, professionalism, ethics, integrity, as well as their ability to inspire the trust of our people and command confidence from our clients. We also enhanced our overall governance process with the addition of two independent directors to our Board of Directors. In addition, over the last year we undertook an enterprise-wide culture assessment with external experts in organizational ethics and culture change, to explore how we can integrate culture more explicitly into our sustainable operating model. We listened, collected and analyzed responses to inform an integrated, comprehensive and multidisciplinary approach to achieve progress toward improving our firm's culture. We believe that our new leaders and directors, our focus on our culture and the quality focused investments and audit quality actions described below, make clear a new tone at the top and underscore our commitment to audit quality.

Internal control and estimates

We have made significant investments in a new audit methodology and the related workflow technology that supports the execution of our audits. These investments in particular are specifically focused on auditing internal controls over financial reporting and estimates. These investments, to be fully implemented in 2020, will ensure a clear alignment of our audit methodology with the auditing standards and the facilitation of audit execution through a new technology platform. Certain elements of the methodology related to risk assessment have been accelerated into 2018 to expedite improvement in the auditing of internal controls over financial reporting and estimates.

Professional skepticism, supervision and review, and engagement quality control review

We recognize the importance of our responsibilities related to professional skepticism, supervision and review, and engagement quality control reviews ("EQCR"), and we have increased training, clarified roles, modified processes, and enhanced accountability to ensure improved execution in these areas. For example, we have enhanced our workflow to require and document early partner and EQCR involvement in key areas of the audit, bringing essential expertise and a critical viewpoint to all phases of the work.

Monitoring programs

We have changed our approach to engagement monitoring and the oversight of our Inspections Group. This group now reports outside of our Audit practice and into our Vice Chairman – Legal, Risk and Regulatory. It serves no engagement support role (that role now being confined to the Audit practice itself), ensuring that its activities are directed solely to a critical assessment of our processionals' performance. The output of our own monitoring and the results of external inspections are synthesized through our root cause analysis to ensure that we develop remedial actions that are responsive to our control deficiencies and meet the standards required of those actions.

KPMG

Accountability

Under new leadership, responsibilities for audit quality have been clearly defined for roles from the engagement partner to the Chairman and CEO, which has given us a framework to ensure accountability for audit quality beyond the engagement team. We have implemented performance assessment and compensation processes to align with those roles and responsibilities. More broadly, we have initiated a project to more clearly delineate core competencies by organizational level. Our training curriculum and promotional processes will align directly to this core competency framework.

Our commitment to continuous improvement

We define audit quality as the outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards, within a strong system of quality controls. We have gained global alignment on this definition to ensure our professionals have a clear vision of our view of quality at both the engagement level and related to our overall system of quality controls. Because the quality of each audit rests on our foundational quality controls, we are building a process to document and continually evaluate our overall system of audit quality controls and our implementation of the quality control standards applicable to our work.

We believe that the significant actions we have taken in the past 18 months demonstrate that we are dedicated to reinforcing a tone at the top that reflects our unwavering commitment to improved audit quality and respect for the regulatory process. We require our professionals to exhibit the highest level of professionalism and integrity and to embrace their roles in driving audit quality and improving our system of audit quality control. We take seriously our responsibility to the capital markets and are committed to continuously improving our firm and working constructively with the PCAOB to maintain the public's trust.

Very truly yours,

KPMG LLP

Lynne M. Doughtie
Chairman and Chief Executive Officer

Frank E. Casal
Vice Chair - Audit

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Report on

2014 Inspection of KPMG LLP
(Headquartered in New York, New York)

Issued by the

Public Company Accounting Oversight Board

October 15, 2015

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

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

PCAOB RELEASE NO. 104-2015-189A
(Includes portions of Part II of the full report that
were not included in PCAOB Release No. 104-2015-189)

PCAOB Release No. 104-2015-189A

2014 INSPECTION OF KPMG LLP

Preface

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

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

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

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures[1] for the inspection from October 2013 to February 2015. The inspection team performed field work at the Firm's National Office and at 29 of its approximately 83 U.S. practice offices.

A. Review of Audit Engagements

The inspection procedures included reviews of portions of 51 issuer audits performed by the Firm and a review of the Firm's audit work on one other issuer audit engagement in which the Firm played a role but was not the principal auditor. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. In addition, in one of the audits described below, after the primary inspection procedures, the Firm revised its opinion on the effectiveness of the issuer's internal control over financial reporting ("ICFR") to express an adverse opinion.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix D to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional

[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.

skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in the references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

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

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

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

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[2] Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Depending upon the circumstances, compliance with PCAOB standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure

The audit deficiencies that reached this level of significance are described in Part I.A.1 through I.A.28, below.

Effects on Audit Opinions

Of the 28 issuer audits that appear in Part I.A, deficiencies in 27 audits relate to testing controls for purposes of the ICFR opinion, and deficiencies in 19 audits relate to the substantive testing performed for purposes of the opinion on the financial statements, as noted in the table below. Of the 19 audits in which substantive testing deficiencies were identified, five audits included deficiencies in substantive testing that the inspection team determined were caused by a reliance on controls that was too high in light of deficiencies in the testing of controls.

	Number of Audits
Deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	18
Deficiencies included in Part I.A related to the financial statement audit only	1
Deficiencies included in Part I.A related to the ICFR audit only	9
Total	28

Most Frequently Identified Audit Deficiencies

The following table lists, in summary form, the types of deficiencies that are included most frequently in Part I.A of this report. A general description of each type is provided in the table; the description of each deficiency in Part I.A contains more specific information about the individual deficiency. The table includes only the five most

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by a firm to take appropriate actions, or a firm's misrepresentations in responding to an inspection report about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

frequently identified deficiencies that are in Part I.A of this report and is not a summary of all deficiencies in Part I.A.

Issue	Part I.A Audits
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing	22 Audits: Issuers A, B, C, D, E, F, G, H, I, K, L, M, N, O, P, Q, R, U, V, Y, Z, and AA
Failure to identify and test any controls that addressed the risks related to a particular account or assertion	12 Audits: Issuers A, D, E, F, G, J, M, O, T, W, X, and Z
Failure to perform sufficient testing related to an account or significant portion of an account or to address an identified risk	10 Audits: Issuers A, B, D, E, I, J, M, N, O, and BB
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate	9 Audits: Issuers A, C, E, G, H, L, P, W, and BB
Failure to sufficiently test controls over, or sufficiently test, the accuracy and completeness of issuer-produced data or reports	6 Audits: Issuers D, F, G, H, N, and O

Audit Deficiencies

A.1. Issuer A

In this audit of an issuer in the financial services industry, 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 and the Firm identified multiple deficiencies in controls over the valuation of the allowance for loan losses ("ALL") and mortgage servicing rights ("MSRs"), as well as transaction-level controls and information technology general controls ("ITGCs"). The Firm concluded that certain of these deficiencies aggregated to a significant deficiency. The Firm, however, failed to sufficiently evaluate the severity of the identified deficiencies in concluding that they were not indicative of a material weakness. Specifically –

    - The issuer used various models in its valuation of the ALL and MSRs. A number of deficiencies were identified in the issuer's model governance and model validation processes, and similar deficiencies had been identified in the prior year. The issuer concluded, and the Firm agreed, that these deficiencies aggregated to a significant deficiency; however, the Firm's procedures to evaluate the severity of these deficiencies were not sufficient. Specifically –

        - For the ALL, the Firm identified compensating controls that consisted of (1) a review of model validation reports and (2) an annual review for triggering events related to certain models. The Firm failed to sufficiently test whether these compensating controls operated at a level of precision that would prevent or detect material misstatements, as the Firm's procedures to test these controls were limited to reading the model validation reports or annual review documents; these reports and documents were dependent on the processes with control deficiencies that are discussed above. (AS No. 5, paragraph 68)

        - For MSRs, the Firm identified compensating controls that consisted of (1) investigating differences between the recorded values of the MSRs and the valuations provided by the issuer's external specialist and (2) investigating differences between estimated and actual prepayments and default rates. The Firm failed to sufficiently test whether these compensating controls operated at a level of precision that would prevent or detect material misstatements, as the

Firm failed to evaluate whether the criteria established by the control owners for the investigation of differences were sufficiently precise to identify such misstatements. (AS No. 5, paragraph 68)

- The Firm identified multiple deficiencies in transaction-level controls and ITGCs at the issuer's business units. The Firm evaluated these deficiencies only at the business-unit level and failed to evaluate whether, in combination, these deficiencies could represent a material weakness. In addition, the Firm failed to aggregate certain other transaction-level and ITGC deficiencies that were identified by the issuer in the Firm's evaluation of the severity of the deficiencies. (AS No. 5, paragraphs 62 and 63)

- The Firm used the work of certain of the issuer's personnel as evidence of the operating effectiveness of (1) 13 ITGCs, certain of which included a manual element, over applications related to the valuation of the issuer's ALL, hard-to-value securities, derivatives, and MSRs and (2) two other manual controls over the valuation of the ALL. The Firm's use of the work of these personnel was not appropriate given (1) the Firm's assessment of these controls as having a higher risk of failure, and (2) the level of the Firm's testing of that work. Specifically, the Firm's testing was limited to reviewing a small portion of this testing for four of the ITGCs and the two other ALL controls. (AS No. 5, paragraph 19; AU 322, paragraphs .20 and .21)

- The Firm failed to perform sufficient procedures related to the valuation of the ALL, for which the Firm had identified a fraud risk. Specifically –

  - The Firm selected for testing a control over the issuer's determination of the ALL, but failed to sufficiently test this control. This control, which was one of the compensating controls discussed above, consisted of management's annual review of each model that it had deemed to have higher risk to determine whether any triggering events had occurred that would require the issuer to perform a full-model validation; these triggering events included (1) a change in the model inputs, theory, or code and (2) a degradation in the model's performance that was not fully understood. The Firm failed to test a significant aspect of the control related to the procedures that the control owners performed to identify the models that had triggering events. In addition, the Firm failed to test another significant aspect of the control related to the issuer's determination as to whether there had been any degradation in the models. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to test ITGCs related to the issuer's user-access and change-management processes over a significant number of the issuer's ALL models or, in the alternative, test other controls over the integrity of these models and the related ALL calculations. (AS No. 5, paragraph 39)

- For the issuer's retail loan portfolios, the Firm failed to perform sufficient substantive procedures to test the issuer's loss-emergence period ("LEP") assumptions, which were the issuer's estimates of the time that would pass between a loss event and the quantification of the loss and the related charge-off. During the year under audit, the issuer made a significant change to its LEP assumption for one of its retail loan portfolios. The Firm failed to evaluate (1) the appropriateness of the data used and judgments made by the issuer in developing its current-year assumption and (2) the reasons for this significant change in the assumption and whether the reasons supported the accounting applied by the issuer. In addition, the Firm failed to sufficiently test the LEP assumption relating to certain of the issuer's other retail loan portfolios. Specifically, the Firm compared the issuer's LEP assumption to certain external data and noted significant inconsistencies between the data and the issuer's assumption, but the Firm failed to investigate those inconsistencies. (AU 342, paragraph .11)

• The Firm failed to perform sufficient procedures related to the valuation of the MSRs, for which the Firm had identified a fraud risk. Specifically –

  - The issuer used internally developed financial models to develop inputs that it then used as significant assumptions in other models to estimate the value of MSRs. The Firm failed to test ITGCs related to user-access and change-management over the models that were used to develop the inputs or, in the alternative, test other controls that addressed the risk of unauthorized changes to these models and related calculations. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test certain significant assumptions that the issuer used to estimate the value of the MSRs. The Firm's procedures consisted of comparisons of the issuer's assumptions to those of selected peers and to data in an industry survey; these comparisons indicated a range of acceptable values for the assumptions. The Firm, however, failed to evaluate whether the selected peer data and the industry survey information, which showed a wide range of values, were relevant indicators of the assumptions for the issuer's MSRs. (AU 328, paragraphs .26, .28, and .31)

- The Firm's substantive procedures to test the valuation of certain available-for-sale ("AFS") securities, including securities without readily determinable fair values ("hard-to-value securities"), were not sufficient. Specifically –

  - To test the valuation of one type of structured security that was approximately eight percent of the issuer's total AFS portfolio and was multiple times the Firm's established materiality level, the engagement team's primary procedure consisted of receiving prices from the Firm's internal pricing service. The pricing service provided a price from only one source for the securities. The Firm's procedures to test the valuation of these securities were insufficient as follows –

    - For certain securities, the Firm failed to (1) revise its initial risk assessment given there was little pricing information available, and (2) obtain an understanding of the specific methods and assumptions underlying those prices or the prices the issuer used. (AS No. 13, paragraph 46; AU 328, paragraphs .26 and .40)

  - For certain other securities, the Firm failed to obtain a sufficient understanding of the specific methods and assumptions underlying the prices, as its testing was limited to reading external reports that it obtained from the issuer; these reports did not specify information about the methods and assumptions used by the issuer to price the securities. (AU 328, paragraphs .26 and .40)

- o The Firm failed to perform any procedures to test the valuation of a certain type of hard-to-value securities, for which the fair value was determined by the issuer through an internal valuation model. (AS No. 13, paragraph 8; AU 328, paragraph .23)

- The issuer used an external organization to provide confirmation-matching services for certain of its derivative transactions. The Firm failed to perform sufficient procedures to determine whether all of these derivative transactions were recorded. Specifically, the Firm failed to sufficiently test controls over the monitoring and resolution of derivative transactions that were reported by the external organization but were not recorded by the issuer because the Firm limited its testing to controls that would not address the risk of unrecorded derivative transactions in a timely manner. In addition, the Firm failed to perform any substantive procedures to address whether unrecorded derivative transactions reported by the external organization as of year end were resolved. (AS No. 5, paragraph 39; AU 332, paragraphs .22 and .23)

A.2. Issuer B

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

- The issuer generated revenue and held inventory at numerous locations, and, in determining the scope of its tests of controls, the Firm assumed that the internal controls, business processes, and transactions at these locations were routine and homogeneous. To support that assumption, the Firm selected and tested a monitoring control that consisted of internal audit ("IA") and other issuer personnel ("OIP") testing transaction-level controls and reviewing the results of periodic self-assessments, performed by other issuer personnel, at a sample of locations. The Firm's procedures to test the operating effectiveness of this monitoring control, however, were insufficient, as they were limited to inquiring of IA and OIP; reviewing IA and OIP work programs, work papers, and audit reports; and assessing the effects of exceptions and/or errors identified by IA and OIP, without testing any of the procedures performed by IA and OIP. The Firm's limitation of its testing of transaction-level controls over revenue and inventory to a small number of locations was inappropriate, as its testing of the monitoring control did not provide sufficient evidence that the controls, business processes, and transactions at the locations were routine and homogeneous. (AS No. 5, paragraphs 44 and B10)

- The Firm failed to perform sufficient procedures to test the existence of certain inventory. The issuer used cycle-count procedures to determine inventory quantities, and the Firm tested the cycle-count procedures at a small number of locations. In addition, the Firm inspected a report related to adjustments recorded for the year as a result of the cycle count procedures, tested a reconciliation of the inventory sub-ledger to the general ledger as of the year end, and performed analytical procedures related to the fourth-quarter cost of sales and services. The Firm designed its procedures based on a level of control reliance that was not supported due to the deficiency in the Firm's testing of the monitoring control that is discussed above. As a result, the number of locations at which the Firm tested cycle counts was too small to provide sufficient evidence. Further, the Firm's analytical procedures provided little to no substantive assurance. Specifically, the Firm used a growth rate derived from the three prior quarters' data to develop its expectations for its analytical procedures, without obtaining evidence that the growth rates for the earlier quarters would be predictive of the fourth-quarter results. (AS No. 13, paragraphs 16, 18, and 37; AU 329, paragraphs .05, .13, and .14)

A.3. Issuer C

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

- The Firm failed to sufficiently evaluate the severity of certain control deficiencies that it identified because it failed to appropriately evaluate the effect of compensating controls. The Firm identified multiple control deficiencies, including deficiencies in controls over the ALL and mortgage repurchase reserve and in ITGCs. The Firm identified three compensating controls that it believed mitigated certain deficiencies, one of which the Firm determined to be ineffective. The Firm's testing of the two other compensating controls was not sufficient. Specifically, for the first control, which consisted of management's review of the issuer's draft financial statements, the Firm's testing was limited to inspecting documentation of the review. For the second control, which consisted of management's review of certain expense calculations, the Firm's procedures were limited to inquiring of management and inspecting email correspondence as evidence that the reviews had occurred. The Firm's procedures to test these controls did not include evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the criteria used by the control owners to identify matters for investigation and the process for investigating and resolving such matters. In addition, the Firm failed to evaluate whether misstatements that had not been prevented by the issuer's controls should have had an effect on its conclusion about the effectiveness of controls. (AS No. 5, paragraphs 68 and B8)

- The Firm failed to perform sufficient tests of controls over the ALL, for which the Firm identified a fraud risk. Specifically –

  - o The Firm selected for testing a control that consisted of a review of the assigned loan grades, which were an important factor in estimating the ALL. This control operated only during the second quarter. The Firm failed to sufficiently test this control. Specifically, the sample size the Firm used in its testing was too small, given the risk associated with the control, to provide the necessary evidence about the effectiveness of the control. In addition, the Firm's procedures were limited to evaluating the scope of the review and inspecting documents created during the review for indications of recommended loan grade changes, without (1) evaluating the conclusions reached by the control owner and (2) identifying any other controls that addressed the risk of material misstatement related to loan grades as of year end and for the remaining portion of the year. (AS No. 5, paragraphs 39, 42, 44, and 46)

- The Firm selected for testing a control that consisted of management's review of an analysis of the ALL. The Firm's procedures were limited to inquiring of, and inspecting documentation reviewed by, management and noting written comments and signatures as evidence of review. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to evaluate the nature and extent of the review procedures performed by the control owner. (AS No. 5, paragraphs 42 and 44)

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

  - The Firm designed its substantive procedures to test the appropriateness of the loan grades – including its sample size – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of the control over assigned loan grades discussed above. As a result, the sample size the Firm used to test the loan grades was too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

  - The Firm failed to test the significant qualitative adjustments the issuer made to certain loss factors that were used in calculating the ALL. (AU 342, paragraph .11)

- The Firm failed to perform sufficient tests of controls over the mortgage repurchase reserve, for which the Firm had identified a fraud risk. Specifically –

  - The Firm selected for testing a control that consisted of management's review of the mortgage repurchase reserve calculation. The Firm's procedures to test this control consisted of inquiring of management, inspecting the issuer's documentation of the mortgage repurchase reserve calculation, and testing the mathematical accuracy of certain aspects of this calculation. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to evaluate the nature and extent of the review procedures performed by the control owner. (AS No. 5, paragraphs 42 and 44)

- The Firm selected for testing a control that consisted of management's review of repurchase requests received from external counterparties, which were used in the calculation of the mortgage repurchase reserve. The Firm's testing of this control was not sufficient. Specifically, the Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to determine whether differences between the issuer's data regarding the repurchase requests that were used in the calculation of the reserve and certain counterparties' correspondence were appropriately investigated and resolved. Further, the Firm failed to ascertain and evaluate the procedures performed by the issuer to verify that the requests by all external counterparties were subject to the control. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform sufficient substantive procedures to test the mortgage repurchase reserve in the following respects –

  - The Firm failed to sufficiently test the completeness of the repurchase requests received from external counterparties that the issuer included in its calculation of the reserve. Specifically, the Firm limited its testing to inquiring of the issuer and obtaining copies of the issuer's correspondence with certain of its counterparties. The Firm, however, failed to investigate, beyond inquiry, a significant difference between the number of repurchase requests reflected in the issuer's data used in the calculation and the number reported to the issuer in correspondence from one of the counterparties. (AU 342, paragraph .11)

- o For one component of the reserve, which the issuer calculated using external loan data as a significant input, the Firm failed to evaluate the relevance and comparability to the issuer's data of the external data. In addition, the Firm failed to sufficiently test the appropriateness of the reserve rate the issuer used to calculate another component of the reserve, as the Firm limited its procedures to comparing the reserve rate used to the issuer's loss experience for loans that had originated several years ago, without evaluating whether the loans and originations in that year were comparable to the relevant loans. (AU 342, paragraph .11)

A.4. Issuer D

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

- This issuer's most significant category of revenue typically consisted of arrangements that included multiple deliverables. The Firm failed in the following respects to perform sufficient procedures related to this category of revenue –

  - o The Firm failed to identify and test any controls over the allocation of the consideration among the separate units of accounting. (AS No. 5, paragraph 39)

  - o With respect to one of the issuer's segments, which reported approximately eighty percent of this revenue, the Firm failed to perform any substantive procedures to test the allocation of the consideration among the separate units of accounting. (AS No. 13, paragraph 8)

- The issuer deferred revenue for two types of transactions in both of its segments. The Firm's procedures related to the deferred revenue were not sufficient, as follows –

- For one of the issuer's two segments, the Firm failed to identify and test any controls over either type of deferred revenue. (AS No. 5, paragraph 39)

- Regarding the other segment –

  - The Firm failed to identify and test any controls over the recording of one type of deferred revenue at the time of billing. (AS No. 5, paragraph 39)

  - The Firm identified a deficiency in a control over the other type of deferred revenue, and it identified a compensating control that it believed mitigated the deficiency. This compensating control consisted of the issuer's review for reasonableness of the deferred revenue based on an analysis of the transactions occurring during the period. The Firm's procedures to test this control were limited to reading the analysis prepared by the control owner. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain and evaluate the criteria used by the control owner to identify matters for investigation and whether such matters were appropriately investigated and resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain data used in the performance of this compensating control. (AS No. 5, paragraphs 39 and 68)

  - The Firm failed to perform sufficient substantive procedures to test the first type of deferred revenue, as its procedures were limited to (1) obtaining a reconciliation and comparing the deferred revenue balance at year end to the general ledger and (2) testing an adjustment recorded to the account for amounts billed that were not due as of year end. (AS No. 13, paragraph 8)

- The Firm identified fraud risks related to revenue recognition, management override of controls, and earnings management. With respect to one of the issuer's segments, and the issuer's discontinued operations, the Firm's procedures related to the testing of journal entries for evidence of possible material misstatement due to fraud, however, were not sufficient. Specifically–

- o To address the risks of inappropriate access to the recording of journal entries and incorrect journal entries, the Firm selected for testing a control that consisted of the review and approval of all manual journal entries; however, the Firm's testing of this control was not sufficient. Specifically, the Firm failed to test whether this control, or any other control that the Firm tested, was designed to limit the input of journal entries to appropriate personnel. (AS No. 5, paragraph 42; AU 316, paragraph .60)

- o The Firm's substantive testing of manual journal entries, and testing of related controls, were not sufficient because the Firm failed to either test controls over the completeness of the population of manual journal entries from which it made selections for testing or substantively test the completeness of that population of manual journal entries. (AS No. 15, paragraph 10; AU 316, paragraph .61)

- In the prior year, the issuer had identified a significant deficiency in controls related to the selection of accounting policies. In the current year, the Firm identified and tested a control consisting of the review by management and the issuer's board of directors of the issuer's reports to be filed with the Securities and Exchange Commission ("SEC"). The Firm concluded that this control, with an additional control owner assigned in the current year, was designed and operating effectively, and that it remediated the deficiency identified in the prior year; the Firm, however, did not (1) obtain evidence that this control addressed the risks of the application of inappropriate accounting policies and (2) identify, and evaluate the effects on its conclusions of, an inappropriate accounting policy for revenue recognition in the current year that was not prevented or detected by this control. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to identify and test any controls over the existence of assets that the issuer leased to its customers. (AS No. 5, paragraph 39)

A.5. Issuer E

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

- The Firm failed to perform sufficient tests with respect to the ALL and the reserve for unfunded commitments, for which the Firm had identified fraud risks. Specifically –

  - o The Firm selected for testing a control that consisted of management's review of the ALL and the calculation of the reserve for unfunded commitments. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements, as its procedures were limited to inquiring whether there had been any changes in the control, obtaining a copy of an email confirming that the review had occurred, and attending certain meetings that constituted part of the review. The Firm's procedures did not include evaluating (1) the metrics or criteria applied as part of the review to identify matters for investigation and (2) whether those identified matters were resolved appropriately. (AS No. 5, paragraphs 42 and 44)

  - o The Firm failed to sufficiently evaluate the reasonableness of the historical loss period ("HLP") assumption, which was the number of periods used to calculate an average historical loss rate, and which was a significant factor in the issuer's calculation of the ALL and reserve for unfunded commitments. Specifically, the Firm limited its procedures to obtaining and reading an issuer-prepared sensitivity analysis, which indicated that in two of three scenarios, if an alternative HLP were used, the ALL would change by a significant amount. (AS No. 14, paragraph 3; AU 342, paragraph .11)

- The Firm failed to perform sufficient tests with respect to the completeness of certain of the issuer's derivatives. Specifically –

- o With respect to the completeness of one category of derivatives, the Firm selected for testing two controls that consisted of (1) the approval of transactions recorded in the issuer's derivative trading system and (2) the automated interface between the issuer's derivative trading system and the general ledger. Neither of these controls, however, addressed the risk of unrecorded derivative activity, and the Firm failed to identify and test any other controls that addressed that risk. In addition, the Firm failed to identify and test any controls over the completeness of another category of derivatives. (AS No. 5, paragraph 39)

- o The Firm's substantive procedures to test the completeness of the issuer's derivatives described above were insufficient, as its procedures were limited to reconciling recorded derivatives in the issuer's derivative trading system to the general ledger. (AU 332, paragraphs .22 and .23)

A.6. Issuer F

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

- The Firm failed to perform sufficient tests of controls over consulting and maintenance revenue, deferred revenue, and accounts receivable related to certain of the issuer's international locations that, in the aggregate, represented a significant portion of the respective consolidated accounts. The Firm identified and tested a control that consisted of management's review of each location's financial information and certain metrics as compared to prior periods and forecasted results, and the investigation of differences over certain thresholds. The Firm's testing of this control was not sufficient. Specifically, the Firm's procedures were limited to inquiring of the control owners, noting comments made by the control owners on the documented analysis, and inspecting emails as evidence of review. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the review procedures that the control owners performed to investigate differences over the thresholds. In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had identified and tested any controls over the accuracy and completeness of the data used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test maintenance revenue, deferred revenue, and accounts receivable related to the issuer's international locations. Specifically –

  - The Firm designed its procedures – including sample sizes – to test maintenance revenue and deferred revenue for all of the issuer's international locations based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of the control that are discussed above. As a result, the sample sizes the Firm used in its testing were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

  - The Firm's planned approach for testing accounts receivable for certain of the issuer's international locations, which accounted for more than a third of the issuer's consolidated accounts receivable at year end, consisted of a test of details of certain accounts receivable at one location and the performance of substantive analytical procedures for all international locations. The analytical procedures that the Firm performed, however, provided little to no substantive assurance. Specifically, the Firm used the prior-year accounts receivable balances to develop its expectations for the current year, but failed to evaluate whether the prior-year balances could be expected to be predictive of the current-year balances. Further, for differences that were in excess of the Firm's threshold for investigation, the Firm limited its procedures to inquiring of management, without obtaining corroboration of the explanations. (AU 329, paragraphs .13, .14, and .21)

- The Firm failed to perform sufficient tests of controls over consulting revenue, deferred revenue, and accounts receivable related to the issuer's domestic locations. Specifically –

- o The issuer recognized consulting revenue as the services were performed based on time and expenses entered into an information technology ("IT") application. The Firm selected for testing a control consisting of the entry and approval of time and expenses within this application. The Firm, however, did not test ITGCs over this system, or application controls that would address how the accuracy and completeness of the time was maintained once it was entered and approved. In addition, the Firm failed to identify and test any controls over the accuracy of a report produced by this application that was used in the operation of another control that the Firm tested over the consulting revenue. (AS No. 5, paragraph 39)

- o The Firm failed to identify and test any controls over the accuracy of a report used in the operation of a control that it tested over accounts receivable. In addition, with respect to a control over deferred revenue that it tested, the Firm failed to test the aspects of the control that addressed the accuracy and completeness of a report used in the operation of the control. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test consolidated consulting revenue. Specifically, the Firm used time entered into the IT application discussed above in its substantive procedures to test the consolidated consulting revenue. The Firm, however, failed to obtain sufficient evidence about the effectiveness of controls over the time once it was entered into the IT application, as discussed above, or, in the alternative, substantively test the accuracy and completeness of the time data that it used. (AS No. 15, paragraph 10)

A.7. <u>Issuer G</u>

In this audit of a supplier of complex products and systems, 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 identified fraud risks related to the (1) recognition of revenue at the end of reporting periods, (2) recognition of revenue from contracts accounted for using the percentage-of-completion ("POC") method, and (3) recognition of revenue from bill-and-hold transactions. The Firm's testing of certain revenue and deferred revenue, however, was not sufficient. Specifically –

  - For revenue at certain subsidiaries, which in combination represented a significant portion of total revenue, the Firm limited its control testing to two controls that consisted of (1) division management's review of the financial reports of the issuer's subsidiaries and (2) corporate management's review of the profit and loss statements of the issuer's divisions. The Firm's testing of these controls was not sufficient. Specifically, the Firm's procedures were limited to inquiring of management, observing discussions that occurred between division and corporate management, reading the issuer's documentation, and inspecting signatures or email correspondence as evidence of review. The Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the level of aggregation of the information used in the reviews, the predictability of the expectations applied in the reviews, the criteria used by the control owners to identify items for follow-up and how those items were resolved, and whether the procedures were applied consistently across these subsidiaries and divisions. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data and reports used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

  - For revenue at one of the issuer's other subsidiaries that was recognized using the POC method, the Firm failed to sufficiently test a control it selected that consisted of reviews of the status of the related contracts. Specifically, the Firm's procedures were limited to inquiring of management and, for two months, (1) obtaining a schedule of contracts accounted for using the POC method and testing the mathematical accuracy of the calculations, (2) comparing billings to supporting documentation, and (3) comparing balances to the related journal entries. The Firm, however, failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. Specifically, the Firm failed to ascertain, and evaluate, the control owner's procedures to assess allowable costs, milestone status, costs incurred, and estimated costs to complete, including the criteria used to identify items for follow-up and how those items were resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the data and reports used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- For revenue at another of the issuer's subsidiaries that was related to bill-and-hold transactions, the Firm selected a control that consisted of a review of relevant documentation of the transactions. The Firm, however, failed to identify and test any controls over the completeness of the transactions that were reviewed as part of the control. (AS No. 5, paragraph 39)

- For deferred revenue at another of the issuer's subsidiaries, the Firm selected a control that consisted of a review of reconciliations between the contract management system and the general ledger. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the data in the contract management system. (AS No. 5, paragraph 39)

- For two of the issuer's subsidiaries discussed above, the Firm failed to perform sufficient substantive procedures to test revenue recognized using the POC method. Specifically –

  - For one of these subsidiaries, the Firm's procedures were limited to, for a sample of contracts, (1) testing the mathematical accuracy of the calculation of revenue that was recognized based upon the achievement of contract milestones, (2) comparing certain contract terms and milestone details to the issuer's system, (3) comparing billed amounts from an issuer-prepared schedule to invoices, and (4) inquiring of management. For these contracts, the Firm failed to obtain evidence about the achievement of milestones, other than through inquiry or from information in the issuer's system, which the Firm did not test. (AU 342, paragraph .11)

- For the other subsidiary, the Firm's procedures were limited to, for a sample of contracts, (1) comparing advance payments included in an issuer-prepared schedule to sales invoices and cash receipts, (2) reading the contract provisions for three contracts, and (3) comparing selected invoices from two of these three contracts to sales orders and shipping documentation. For the contracts in its sample, the Firm failed to test the accuracy and completeness of costs incurred to date and the estimated costs to complete. (AU 342, paragraph .11)

- The Firm failed to perform sufficient tests with respect to goodwill. Specifically –

  - The Firm's testing of a control that it selected over the valuation of goodwill, which consisted of management's review and approval of impairment analyses, was not sufficient. Specifically, the Firm's procedures were limited to inquiring of management, inspecting the impairment analyses, and observing the control owner's review of the impairment analyses. The Firm failed to test whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain, and evaluate, the criteria used by the control owner to identify items for follow-up and how those items were resolved. (AS No. 5, paragraphs 42 and 44)

  - The Firm failed to perform sufficient substantive procedures to test the valuation of goodwill, as it failed to sufficiently evaluate the reasonableness of certain significant assumptions that the issuer used in its annual analysis of the possible impairment of goodwill for one of its reporting units. Specifically, the Firm's procedures to evaluate the issuer's revenue growth projections and long-term growth rates, both of which were significantly higher than recent years' growth rates, were limited to inquiring of management, reading certain revenue contracts, and considering certain economic factors. The Firm failed to obtain evidence (1) that management had the ability to carry out its plans, and had support for its expectations, that drove the higher growth projections and (2) that the plans and expectations could produce the projected results. In addition, the Firm obtained an understanding of how management developed the discount rate applicable to the issuer overall, but failed to evaluate whether that discount rate was relevant to this specific reporting unit. (AS No. 14, paragraph 3; AU 328, paragraphs .26, .28, .31, and .36)

A.8. Issuer H

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

- The Firm failed to perform sufficient tests with respect to the ALL, for which the Firm identified a fraud risk. Specifically –

  - The Firm selected for testing a control that consisted of management's review of the assigned loan grades for certain loans; the loan grades were an important factor in estimating the ALL. The population from which the Firm selected its sample was not confined to the loans that were reviewed as part of this control. As a result, nearly half of the loans in the Firm's sample for testing had not been subjected to the control and, therefore, the Firm failed to sufficiently test this control. In addition, the Firm designed its procedure as a dual-purpose test and the sample size was too small to provide the Firm with the necessary level of substantive assurance, as the risk factor the Firm used to calculate its sample size was inconsistent with its own risk assessment. (AS No. 5, paragraph 44; AU 350, paragraphs .19, .23, and .23A)

  - The Firm selected for testing a control that consisted of (1) an external review of the model the issuer used to derive a significant assumption used to calculate the quantitative component of the ALL and (2) management's review of the results of the external review. The Firm limited its procedures to test this control to inquiring of management and reading the external review report and the memorandum documenting management's consideration of it. The Firm's testing did not include evaluating the process for addressing the significant issues that the external reviewer identified through the operation of the control and the appropriateness of the resolution of those issues. As a result, the Firm failed to determine whether this control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain data and assumptions used in the operation of this control. (AS No. 5, paragraphs 39, 42, and 44)

- The model noted above was developed by a third party using external loss-experience data. The Firm's substantive testing of the quantitative component of the ALL was insufficient in that the Firm failed to evaluate whether the external data used to develop the model were relevant and comparable to the issuer's loss experience. (AU 342, paragraph .11)

- The issuer developed a qualitative component of its ALL, which represented a significant portion of the total ALL, by considering certain internal and external reserve factors for each of its loan products. The Firm failed to perform sufficient substantive procedures to test the factors used to develop this component, as its procedures were limited to obtaining an understanding of the annual changes to these factors, reading the issuer's explanations for changes in these factors, and comparing certain amounts to the issuer's narratives. The Firm failed to evaluate whether the amounts used for each of these factors were reasonable. In addition, the Firm failed to evaluate whether the qualitative adjustments that were incorporated into the model described above by its developer had the effect of duplicating the issuer's use of the reserve factors to develop its qualitative component of the ALL. In addition, in evaluating the reasonableness of the increase in the qualitative component from the prior year's amount, the Firm failed to take into account the decrease in certain other components of the ALL over the same period. (AU 342, paragraph .11)

- o The Firm failed to perform sufficient substantive procedures to test the issuer's loan charge-offs and recoveries, which were important inputs in the calculation of the ALL. Specifically, the sample the Firm used in its testing was too small to provide the necessary level of assurance, as the risk factor the Firm used to calculate its sample size was inconsistent with its own risk assessment. (AU 342, paragraph .11; AU 350, paragraphs .19, .23, and .23A)

- The Firm used the work of the issuer's IA as evidence of the operating effectiveness of certain controls over deposit liabilities and certain ITGCs over important applications related to deposits and the ALL. The Firm's use of the work of IA was not appropriate. Specifically, the Firm assessed some of these controls as having a higher risk of failure and the others included a manual element, and the Firm tested only one to three items per control out of IA's samples of multiple items for each control. (AS No. 5, paragraph 19; AU 322, paragraphs .20 and .21)

- The issuer disclosed that it made loans to certain related parties in the normal course of business and that the terms of these loans were similar to those prevailing for comparable transactions. The Firm failed to perform sufficient tests with respect to these disclosures. Specifically –

- o The Firm selected for testing three controls that it considered to operate in combination over the issuer's financial statement disclosures. These controls consisted of (1) management's review of the financial statements and related disclosures, (2) management's completion and review of a financial statement disclosure checklist, and (3) the review of the financial statements and related disclosures by the issuer's disclosure committee and audit committee. The Firm failed to sufficiently test two of these controls. Specifically, for one of these controls, the Firm's testing of operating effectiveness was limited to observing sign offs as evidence of the review of the disclosure checklist. For the other control, the Firm's procedures were limited to inquiring of management, observing signatures as evidence that the reviews had occurred, reading minutes of certain committee meetings, and attending one audit committee meeting at which the financial statement reviews were discussed. For both of these controls, the Firm failed to (1) ascertain the nature of the review procedures that the control owners performed and (2) ascertain and evaluate the specific criteria used by the control owners to identify matters for follow up and whether such matters were appropriately resolved. As a result, the Firm failed to determine whether these controls operated at a level of precision to prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- o The Firm failed to perform sufficient substantive procedures to test the issuer's financial statement disclosure regarding loans to related parties. Specifically, the Firm failed to address the apparent inconsistencies between the disclosure described above and loan information it had obtained and evaluated during its loan-grade testing. In addition, the Firm failed to sufficiently test the completeness of the schedule the issuer used to prepare these disclosures. Specifically, the Firm's procedures were limited to testing certain loans included on this schedule, without testing whether the schedule included all related-party loans. (AS No. 14, paragraph 3; AS No. 15, paragraph 10)

A.9. Issuer I

In this audit of a manufacturer and marketer of consumer products, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The Firm failed to perform sufficient procedures related to inventory with respect to one of the issuer's segments, which held approximately half of the issuer's total inventory. Specifically –

- The Firm selected for testing a control over the inventory cycle counts. Approximately 40 percent of this segment's inventory was held at multiple external warehouses that operated on three different warehouse management systems. The Firm tested the cycle counting control at two of these warehouses. The Firm did not obtain evidence to support its assumption that the issuer's controls over the inventory held at the external warehouses were homogeneous, and therefore its testing at only two of the warehouses was not sufficient to support its conclusion that the controls were designed and operated effectively. (AS No. 5, paragraph B10)

- The Firm failed to perform sufficient procedures to test the existence of the majority of the inventory held at the external warehouses. Specifically, for this portion of the inventory, which represented a significant proportion of the issuer's current assets, the Firm failed to perform any procedures beyond obtaining confirmations from certain of the custodians. (AU 331, paragraph .14)

A.10. Issuer J

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The value of the majority of the issuer's inventory was adjusted at the end of each periodic reporting period to reduce the recorded balance to the lower of cost or market; the Firm, however, failed to identify and test any controls over the calculation of the inventory's cost. The Firm also failed to perform sufficient substantive procedures to test the valuation of this inventory. Specifically, the Firm's procedures to test the calculation of the inventory's cost were limited to obtaining an issuer-prepared memorandum that described the process for calculating the inventory's cost and inspecting certain of the calculations in an issuer-prepared spreadsheet. (AS No. 5, paragraph 39; AS No. 13, paragraph 8)

A.11. Issuer K

In this audit of an issuer in the financial services industry, 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 its procedures related to the issuer's ALL, for which the Firm identified a fraud risk, were not sufficient. Specifically –

- The Firm failed to perform sufficient tests of controls over the ALL. Specifically, the Firm selected for testing a control that consisted of management's review of assigned loan grades for certain loans; the loan grades were an important factor in estimating the ALL. The population from which the Firm selected its sample was not confined to the loans that were reviewed as part of this control. As a result, half of the loans in the Firm's sample for testing had not been subjected to the control and, therefore, the Firm failed to sufficiently test this control. (AS No. 5, paragraph 44)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically, the Firm designed its substantive procedures to test the appropriateness of the assigned loan grades – including its sample size – based on a level of control reliance that was not supported due to the deficiency in the Firm's testing of the control over loan grades discussed above. As a result, the sample size the Firm used to test the loan grades was too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.12. Issuer L

In this audit of an issuer in the financial services industry, 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 its procedures related to the issuer's ALL, for which the Firm identified a fraud risk, were not sufficient. Specifically –

- The Firm selected for testing a control over the ALL that consisted of management's review of the ALL. The operation of this control included the computation of a range for the general component, which accounted for the majority of the ALL, by the CFO, who estimated the range by making subjective adjustments to historical loss rates. The CFO then performed further procedures if the recorded general component for any specific category fell outside the calculated range. The Firm's testing of this control was limited to inquiring of the control owner and inspecting documentation used in the operation of the control. The Firm, however, failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements. Specifically, the Firm failed to assess whether the procedures that the control owner performed effectively addressed the appropriateness of the important factors and assumptions used to determine the ALL. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically, the Firm limited its procedures to reading certain issuer-prepared documentation, testing the mathematical accuracy of the ALL calculation, comparing certain amounts to supporting documentation, and comparing the ALL balance to the general ledger, without testing the important assumptions used to determine the general component of the ALL. (AU 342, paragraph .11)

A.13. Issuer M

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

- The Firm failed to sufficiently test certain controls over revenue that it selected for testing. Specifically –
    - The Firm selected one control that it considered to address the allocation of revenue to the elements of multiple-element arrangements. This control consisted of the review and approval of each new revenue arrangement for proper input into the issuer's system. The Firm's procedures to test this control were not sufficient, as they were limited to, for a sample of revenue arrangements, (1) noting that the arrangements had been reviewed for proper set-up in the issuer's accounting system and (2) comparing details of the arrangements in the issuer's sales order system to the issuer's accounting system. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the control addressed the risks related to the allocation of revenue to the elements of multiple-element arrangements. (AS No. 5, paragraphs 42 and 44)
    - For another control, which consisted of the monthly review of various aspects of revenue arrangements, the Firm's procedures were limited to (1) inquiring of management, (2) inspecting signatures and notes on reports used in the operation of the control as evidence that the reviews occurred, and (3) testing reports used

in the operation of the control for completeness. The Firm failed to evaluate whether this control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to ascertain and evaluate (1) the nature of the reviews performed and (2) the criteria used by the control owners to identify matters for investigation and whether such matters were appropriately investigated and resolved. (AS No. 5, paragraphs 42 and 44)

- The Firm was aware of (1) allegations of improprieties related to certain types of sales perpetrated by particular employees at certain foreign operations and (2) the lack of proper approval of certain sales agreements, specifically related to the specified discounts, at these foreign operations. The Firm's procedures to address these risks were not sufficient. Specifically –

    - The Firm concluded that controls over revenue at these foreign operations were operating effectively, without (1) identifying and testing any controls over the approval of sales agreements related to these foreign operations and (2) evaluating the effects on its conclusion of the lack of proper approval of certain sales agreements, including the specified discounts. (AS No. 5, paragraphs 39 and 48)

    - The Firm failed to either evaluate the appropriateness or determine the magnitude of the revenue and discounts recorded with respect to sales agreements that lacked proper approval. (AS No. 13, paragraph 13)

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

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

- The Firm identified a fraud risk related to the recognition of revenue, but failed to perform sufficient procedures to test the operating effectiveness of two controls over cash and credit card receipts that it selected for testing and that it identified as being responsive to this risk. Specifically, the Firm's procedures did not include any testing of the procedures performed by the control owners to reconcile sales revenue recorded in the issuer's general ledger to the cash and credit card receipts. (AS No. 5, paragraph 44)

- The Firm's procedures to test the valuation of property and equipment were insufficient. The issuer performed an annual analysis of the possible impairment of the property and equipment at its stores, using cash-flow data for the individual stores for three preceding years. The issuer also used the cash-flow data in the operation of a control over the valuation of property and equipment that the Firm tested, and the Firm used the cash-flow data in its substantive testing. The Firm, however, failed to identify and test any controls over the cash-flow data and failed to substantively test the data, other than by comparing the data to a report that it had not tested. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)

- The Firm understood that certain inventory, for which the recorded value was several times the Firm's established materiality level, was in-transit between the issuer's receiving facilities and some of its other facilities at year end. The Firm failed to perform sufficient substantive procedures to test this inventory. Specifically, the Firm's procedures to test the existence of this inventory were limited to comparing the quantity, shipping date, and order identification numbers, for a sample of items, from the issuer's inventory ledger to the issuer's system that contained shipping information received from its suppliers. In addition, the Firm failed to perform any procedures to test the valuation of this inventory. (AS No. 13, paragraph 8)

A.15. Issuer O

In this audit of a manufacturer of industrial components and provider of related services, 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 identified a fraud risk related to revenue. The Firm's testing of controls over revenue and accounts receivable, however, was insufficient. Specifically –

  - With respect to one of the issuer's segments, which consisted of three business units, the Firm failed to identify and test any controls over revenue and accounts receivable for two of the business units, which, in combination, represented a significant portion of the issuer's total revenue and accounts receivable. (AS No. 5, paragraph 39)

  - For the third business unit, and for another segment, the Firm used the work of the issuer's IA as evidence of the operating effectiveness of certain controls, including three manual controls that the Firm considered to be responsive to the fraud risk. The Firm's use of the work of IA for these three controls was not appropriate given the risk associated with the controls, due to the identified fraud risk, and the level of the Firm's testing of that work. This testing was limited to re-performing only a small portion of IA's testing of these controls and, for one control, examining only a small number of similar transactions that were not tested by IA. (AS No. 5, paragraph 19; AU 322, paragraphs .20 and .21)

- The Firm identified a fraud risk related to management override of controls. The Firm's procedures related to the testing of journal entries for evidence of possible material misstatement due to fraud, however, were insufficient. Specifically, with respect to the issuer's segment noted above that consisted of three business units –

  - The Firm failed to perform any procedures to test journal entries for two of the three business units within this segment. (AU 316, paragraph .58)

  - For the third business unit, the Firm's strategy included testing a control that consisted of a review of all journal entries, by an independent, authorized person, for appropriate documentation and recording. The Firm selected a sample of journal entries to test whether they were reviewed and approved by such a person. In reaching its conclusion that this control was operating effectively, however, the Firm failed to recognize and consider that more than 10 percent of the journal entries that the Firm tested were reviewed and approved by one of the journal entry preparer's subordinates. (AS No. 5, paragraph 14; AS No. 13, paragraphs 13 and 34)

- The Firm failed to perform sufficient tests related to the valuation of inventory for one of the issuer's segments, which held a significant portion of total inventory. Specifically –

    - For a portion of inventory that was valued using the average cost method, the Firm failed to identify and test any controls over the calculation of the average cost. (AS No. 5, paragraph 39)

    - For a portion of inventory that was accounted for using standard costs, the Firm selected for testing a control that consisted of management's review of variances between actual and standard costs, but it failed to identify and test any controls over the accuracy and/or completeness of certain data and a schedule that were used in the performance of this control. (AS No. 5, paragraph 39)

    - With respect to the reserve for excess and obsolete inventory, the Firm selected for testing a control that consisted of the calculation of the reserve. The Firm, however, failed to identify and test any controls over the accuracy and completeness of certain data used in the performance of this control. (AS No. 5, paragraph 39)

    - The Firm failed to perform sufficient substantive procedures to test the valuation of inventory for this segment. The Firm designed its substantive procedures – including sample sizes – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the sample sizes the Firm used in its testing were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.16. Issuer P

In this audit of an issuer in the financial services industry, 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 its procedures related to the issuer's ALL, for which the Firm identified a fraud risk, were not sufficient. Specifically –

- The Firm failed to perform sufficient tests of the operating effectiveness of controls over the ALL. Specifically –

  - The Firm selected for testing a control that consisted of management's review of the assigned loan grades for certain loans; the loan grades were an important factor in estimating the ALL. The population from which the Firm selected its sample was not confined to the loans that were reviewed as part of this control. As a result, the majority of the loans in the Firm's sample for testing had not been subjected to the control and, therefore, the Firm failed to sufficiently test this control. (AS No. 5, paragraph 44)

  - The Firm selected for testing a control that consisted of management's review of an analysis of the ALL. The Firm's testing of the operating effectiveness of this control was limited to reading the analysis, testing the mathematical accuracy of the ALL calculation, and comparing certain inputs to supporting documentation. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to evaluate management's process for investigating and resolving matters identified for follow-up. (AS No. 5, paragraph 44)

- The Firm failed to perform sufficient substantive procedures to test the ALL. Specifically, the Firm failed to sufficiently test certain components of the ALL, which, in the aggregate, were several times the Firm's established level of materiality. To test these components, the Firm obtained an understanding of how they were determined, inspected certain worksheets and documentation related to the components, tested the mathematical accuracy of certain calculations, and considered certain changes in one of these components. The Firm, however, failed to test the underlying data and assumptions. (AU 342, paragraph .11)

A.17. Issuer Q

The Firm was engaged by the principal auditor of an issuer in the financial services industry to perform certain procedures on the financial statements and ICFR of a component of the issuer to support the principal auditor's opinion on the consolidated financial statements and ICFR of the issuer. The Firm failed to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit as its procedures to test the specific reserve portion of the component's ALL were insufficient. Specifically –

- The Firm selected for testing a control that consisted of management's review of assigned loan grades for certain loans; the loan grades were an important factor in determining the loans that required a specific reserve. The population from which the Firm selected its sample was not confined to the loans that were reviewed as part of this control. As a result, the majority of the loans in the Firm's sample for testing had not been subjected to the control and, therefore, the Firm failed to sufficiently test this control. In addition, an important aspect of this control related to evaluating the accuracy of the assigned loan grades. For loan grades that the issuer had reviewed as part of this control, the Firm failed in its testing of the control to use the information that the issuer had used in performing the aspect of the control related to the accuracy of the assigned loan grades and, as a result, the procedures that the Firm performed did not provide evidence that the control was operating effectively. (AS No. 5, paragraph 44)

- The Firm designed its substantive procedures to test the specific reserve portion of the ALL – including its sample size – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of the control that are discussed above. As a result, the sample size the Firm used to test this portion of the ALL was too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.18. Issuer R

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The issuer used an external service organization to administer pricing and reporting activities for its available-for-sale securities; the majority of these securities was disclosed as level 2 in the fair value hierarchy set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 820, *Fair Value Measurement*. The Firm failed to obtain sufficient evidence of the design and operating effectiveness of relevant controls. The Firm obtained a service auditor's report as of six months before year-end and a letter from the service organization that indicated that certain unidentified changes had been made to its controls last six months of the year under audit. Although the Firm made inquiries of management, the Firm failed to determine the nature and evaluate the significance of the changes in the service organization's controls. (AS No. 5, paragraphs B24 and B25)

A.19. Issuer S

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as the Firm failed to perform sufficient procedures to test controls over goodwill. During the year, the issuer reorganized its operating segments and, as a result, reassigned goodwill to its reporting units. The Firm identified a deficiency in a control over the reassignment of goodwill to the issuer's reporting units, and it identified a compensating control, consisting of a review of the annual goodwill impairment analysis, that it believed mitigated this deficiency. The Firm, however, failed to sufficiently test this control. Specifically, the Firm's procedures were limited to conducting discussions with management, observing discussions that occurred as part of the review of the analysis, determining that variances in assumptions were investigated, and testing certain data used in the analysis. These procedures did not include an evaluation of whether the compensating control would prevent or detect misstatements related to the reassignment of goodwill to the reporting units. (AS No. 5, paragraph 68)

A.20. Issuer T

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The issuer recognized revenue on the sale of its products at the time of shipment. The Firm identified a fraud risk related to the recognition of revenue at or near the end of a reporting period, but it failed to perform sufficient procedures to identify and test controls that addressed this risk. Specifically, the Firm's testing focused on a control that addressed whether the correct products and quantities were packaged and ready for shipment, but the Firm failed to test any controls that addressed whether shipment had occurred at the time of revenue recognition. (AS No. 5, paragraph 39)

A.21. Issuer U

In this audit of a retailer, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing a control over the issuer's revenue from credit and debit card transactions, which constituted approximately one-third of the issuer's revenue. This control included a reconciliation of this revenue, at a division level, between the issuer's sales revenue and reports from credit and debit card processors. The Firm's testing of the aspect of this control that consisted of this reconciliation was not sufficient. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed procedures, beyond inquiring of management, to test the design effectiveness of this aspect of the control. In addition, with respect to the Firm's testing of the operating effectiveness of this aspect of the control, the Firm tested a sample of daily sales from credit and debit card transactions by store by comparing the amounts to supporting documents and reports; however, the items tested by the Firm were not part of this aspect of the control, which involved reconciling balances at the division level. (AS No. 5, paragraphs 42 and 44)

A.22. Issuer V

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. During the year, the issuer acquired two significant businesses. The Firm selected for testing a control over the accounting for business combinations that consisted of management's review of the valuation assumptions and the external valuation reports for each business combination. The Firm's testing of this control was not sufficient. Specifically, the Firm limited its testing to inquiring of management, reading issuer-prepared memoranda summarizing the transactions and the methods that the issuer used to determine the assumptions, and opining that the assumptions were supported within the memoranda. The Firm's procedures did not include any testing of the effectiveness of management's review of the reasonableness of the assumptions used to determine the fair value of the acquired intangible assets and goodwill. (AS No. 5, paragraphs 42 and 44)

A.23. Issuer W

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

- The Firm failed to test any controls over the reserve for excess and obsolete inventory. (AS No. 5, paragraph 39)

- The issuer calculated a significant portion of the reserve for excess and obsolete inventory by (1) generating a report that identified inventory that might require a reserve and (2) adjusting the amount indicated in this report for items that management determined did not require a reserve. The Firm failed to perform sufficient substantive procedures to test the reserve. Specifically, while the Firm compared the magnitude of the current-year adjustments to those in prior years and tested certain of the adjustments, the Firm failed to test a significant portion of management's adjustments to the reserve, which were substantial. (AU 342, paragraph .11)

A.24. Issuer X

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. Specifically, the Firm failed to identify and test any controls over the accuracy and completeness of certain data that the issuer provided to its external actuary and that the external actuary used to calculate certain of the issuer's post-retirement benefit obligations. While the Firm considered a control that it tested, which consisted of management's review of the financial statements, to provide assurance regarding the accuracy and completeness of the data, the Firm did not obtain evidence that this control operated at a level of precision to prevent or detect material misstatements related to inaccurate or incomplete data. (AS No. 5, paragraph 39)

A.25. Issuer Y

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The issuer's inventory system automatically calculated a reserve for excess and obsolete inventory based upon certain parameters and assumptions, including inventory on hand and projected demand, and management made manual adjustments to this calculated reserve on a quarterly basis. The Firm selected for testing a control over the reserve for excess and obsolete inventory that consisted of a quarterly review of a reconciliation of the inventory system to the general ledger, which included the manual adjustments to the reserve for excess and obsolete inventory. The Firm's testing of this control was not sufficient. Specifically, the Firm's testing was limited to (1) inquiring of the control owner as to whether she had reviewed the reconciliation, (2) tracing certain amounts in the reconciliation to the system and the general ledger, (3) tracing certain amounts in the reconciliation to supporting documents, (4) determining that the related journal entries had been approved, and (5) noting sign-off as evidence of the review of the reconciliation. The Firm's testing did not include evaluating the specific review procedures that the control owner performed. As a result, the Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

A.26. Issuer Z

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing a control over the issuer's inventory reserve, which consisted of management's review of a reserve analysis. The Firm failed to sufficiently test this control, as its procedures were limited to (1) inquiring of management; (2) noting, as evidence of review, a signature, comments, and explanations on the analysis; and (3) comparing certain amounts in the analysis to the general ledger. The Firm failed to ascertain the nature of the review procedures performed by the control owner and failed to evaluate the specific criteria used by the control owner to identify matters for investigation; therefore, the Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the existence of inventory held at non-issuer-owned locations. (AS No. 5, paragraphs 39, 42, and 44)

A.27. Issuer AA

In this audit of an issuer in the financial services industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as its procedures to test controls over the issuer's ALL, for which the Firm identified a fraud risk, were not sufficient. Specifically –

- The Firm selected for testing a control that consisted of management's documentation and review of significant assumptions used in the determination of the ALL. The Firm's procedures to test this control were limited to inquiring of the control owners, inspecting the documentation prepared and reviewed as part of the operation of the control, and comparing certain data in the documentation to the calculation of the ALL. The Firm's testing did not include (1) ascertaining the nature of the review procedures that the control owner performed and (2) ascertaining and evaluating the specific criteria used by the control owner to identify matters for investigation and whether such matters were appropriately investigated and resolved. As a result, the Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The Firm selected for testing a control that consisted of management's review of the assigned loan grades for certain loans; the loan grades were an important factor in estimating the ALL. The population from which the Firm selected its sample was not confined to the loans that were reviewed as part of this control. As a result, the majority of the loans in the Firm's sample for testing had not been subjected to the control and, therefore, the Firm failed to sufficiently test this control. (AS No. 5, paragraph 44)

A.28. Issuer BB

In this audit of an issuer in the financial services industry, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as its procedures to test the issuer's ALL, for which the Firm identified a fraud risk, were insufficient. Specifically –

- The Firm failed to sufficiently evaluate the issuer's LEP assumption of three months, which was the issuer's estimate of the time that would pass between a loss event and the related charge-off, and which was a significant factor in the issuer's calculation of the quantitative component of the ALL. Specifically, the Firm's testing was limited to performing a sensitivity analysis using an LEP of one year. The sensitivity analysis indicated a quantitative component of the ALL that was higher by a significant amount. The Firm concluded that the issuer's use of a large qualitative component resulted in a total ALL that was representative of losses greater than one year. The Firm failed, however, to perform any procedures to support this conclusion. The Firm also failed to consider that the issuer's portfolio included a significant portion of commercial loans, which the Firm noted, based on its industry knowledge, typically experienced an LEP that was more than one year. (AU 342, paragraph .11)

- The Firm failed to sufficiently evaluate the reasonableness of the qualitative component of the ALL, which represented more than half of the total ALL, as its procedures were limited to reading an issuer-prepared analysis of changes in this component during the fourth quarter. In addition, the Firm identified a fraud risk related specifically to the risks associated with the assumptions underlying the qualitative component of the ALL, but the Firm failed to perform tests that were specifically responsive to this risk. (AS No. 13, paragraph 13; AU 342, paragraph .11)

B. Auditing Standards

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

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

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

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

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

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

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An*	Issuer A Issuer B	8 1

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
Audit of Financial Statements	Issuer C	5
	Issuer D	7
	Issuer E	2
	Issuer F	3
	Issuer G	5
	Issuer H	4
	Issuer I	1
	Issuer J	1
	Issuer K	1
	Issuer L	1
	Issuer M	3
	Issuer N	2
	Issuer O	6
	Issuer P	2
	Issuer Q	1
	Issuer R	1
	Issuer S	1
	Issuer T	1
	Issuer U	1
	Issuer V	1
	Issuer W	1
	Issuer X	1
	Issuer Y	1
	Issuer Z	1
	Issuer AA	2
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer A	2
	Issuer B	1
	Issuer C	1
	Issuer D	2
	Issuer F	1
	Issuer J	1
	Issuer K	1
	Issuer M	1

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
	Issuer N Issuer O Issuer Q Issuer BB	1 2 1 1
AS No. 14, *Evaluating Audit Results*	Issuer E Issuer G Issuer H	1 1 1
AS No. 15, *Audit Evidence*	Issuer D Issuer F Issuer H Issuer N	1 1 1 1
AU 316, *Consideration of Fraud in a Financial Statement Audit*	Issuer D Issuer O	1 1
AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*	Issuer A Issuer H Issuer O	1 1 1
AU 328, *Auditing Fair Value Measurements and Disclosures*	Issuer A Issuer G	4 1
AU 329, *Substantive Analytical Procedures*	Issuer B Issuer F	1 1
AU 331, *Inventories*	Issuer I	1
AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*	Issuer A Issuer E	1 1
AU 342, *Auditing Accounting Estimates*	Issuer A Issuer C	1 3

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
	Issuer E Issuer G Issuer H Issuer L Issuer P Issuer W Issuer BB	1 2 3 1 1 1 2
AU 350, *Audit Sampling*	Issuer C Issuer F Issuer H Issuer K Issuer O Issuer Q	1 1 2 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 each deficiency included in Part I.A of this report and identifies the audits described in Part I.A where deficiencies relating to the respective areas were observed.[3]

	AS No. 5	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 332	AU 342	AU 350
Business combinations	V									
Derivatives	A, E							A, E		
Fixed assets	N			N						

[3] Certain deficiencies that affect multiple accounts or areas, such as those related to (1) the use of the work of others, (2) the testing of journal entries, and (3) the evaluation of control deficiencies, are excluded from this table, but are included in Appendix D.

	AS No. 5	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 332	AU 342	AU 350
Impairment of goodwill	G,S		G		G					
Inventory and related reserves	B, D, I, J, O, W, Y, Z	B, J, N, O				B	I		W	O
Investment securities	R	A			A					
Loans and ALL, including reserve for unfunded commitments	A, C, E, H, K, L, P, Q, AA	C, K, Q, BB	E						A, C, E, H, L, P, BB	C, H, K, Q
Mortgage servicing rights	A				A					
Post-retirement benefit obligations	X									
Related party transactions	H		H	H						
Repurchase reserve	C								C	
Revenue, including accounts receivable and deferred revenue	B, D, F, G, M, N, O, T, U	D, F, M		F		F			G	F

B.3. Audit Deficiencies by Industry

The table below lists the industries[4] of the issuers for which audit deficiencies were discussed in Part I.A of this report, along with the specific auditing standards related to the deficiencies and the number of issuer audits where those deficiencies were observed.[5] Because an issuer audit may have deficiencies that relate to more than one standard, the total for each row should not be read as the total number of issuers.

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[4] 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.

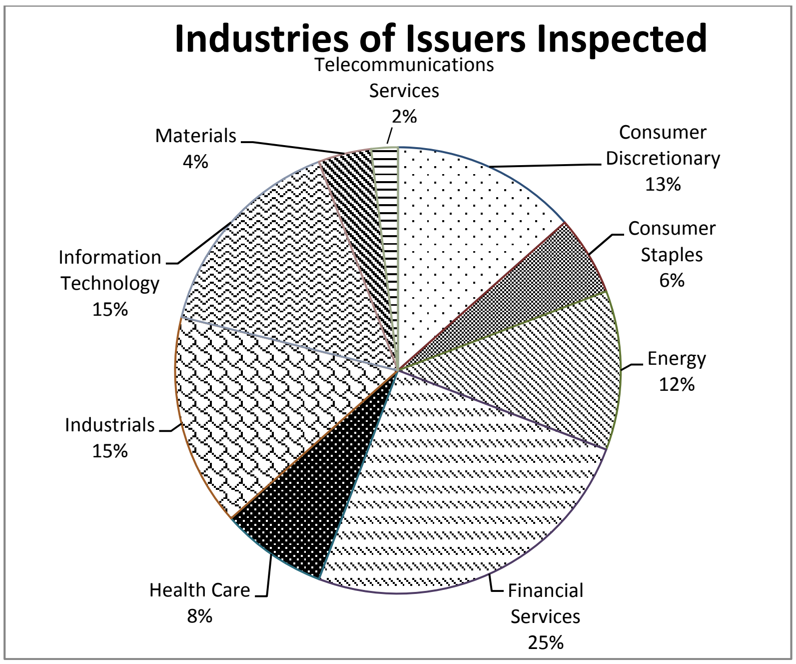
[5] Where identifying the industry of the issuer may enhance the understanding of the description of a deficiency in Part I.A, industry information is also provided there, unless doing so would have the effect of making the issuer identifiable.

	AS No. 5	AS No. 13	AS No. 14	AS No. 15	AU 316	AU 322	AU 328	AU 329	AU 331	AU 332	AU 342	AU 350
Consumer Discretionary	3	2		1								
Consumer Staples	2								1			
Energy	2	1						1				
Financial Services	9	5	2	1		2	1			2	7	4
Health Care	3										1	
Industrials	4	2	1	1	2	1	1				1	1
Information Technology	3	2		1				1				1
Telecommunication Services	1											

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

C.1. Industries of Issuers Inspected

The chart below categorizes the 52 issuers whose audits were inspected in 2014, based on the issuer's industry.[7]



Industry	Number of Audits Inspected	Percentage
Consumer Discretionary	7	13%
Consumer Staples	3	6%
Energy	6	12%
Financial Services	13	25%
Health Care	4	8%
Industrials	8	15%
Information Technology	8	15%
Materials	2	4%
Telecommunication Services	1	2%

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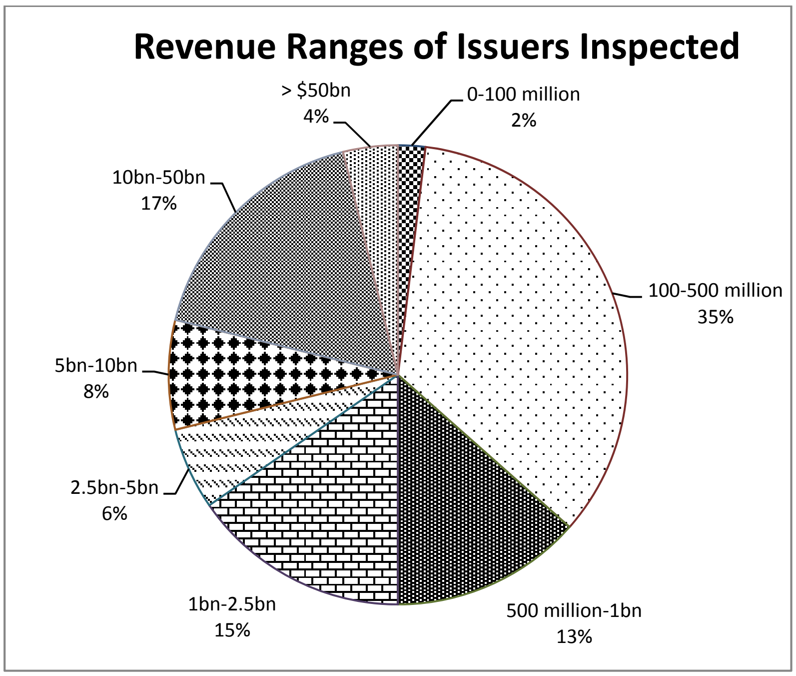
[6] Where the audit work inspected related to an engagement in which the Firm played a role but was not the principal auditor, the industry and the revenue included in the tables and charts in this section are those of the entity for which an audit report was issued by the primary auditor. As discussed above, the inspection process included reviews of portions of 51 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 4 for additional information on how industry sectors were classified.

C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 52 issuers whose audits were inspected in 2014.[8] This presentation of revenue data is intended to provide information about the size of issuer audits that were inspected and is not indicative of whether the inspection included a review of the Firm's auditing of revenue in the issuer audits selected for review.



Revenue (in US$)	Number of Audits inspected	Percentage
0 - 100 million	1	2%
100-500 million	18	35%
500 million – 1 billion	7	13%
1-2.5 billion	8	15%
2.5-5 billion	3	6%
5-10 billion	4	8%
10-50 billion	9	17%
>50 billion	2	4%

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

Board inspections include reviews of certain portions of selected audit work performed by the inspected firm and reviews of certain aspects of the firm's quality

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.

control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

D.1. Reviews of Audit Work

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

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[9] as well as a

[9] 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 SEC, 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

firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection of an annually inspected firm does not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS No. 3, *Audit Documentation,* provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, an inspection team considers whether audit documentation or any other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

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.[10]

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issues unless otherwise expressly stated.

[10] The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

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

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

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

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.

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 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

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[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.

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

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

Procedures in this area are designed to focus on (1) whether the firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as distinct from marketing or other activities of the firm; (2) the firm's processes for allocating its partner resources; and (3) the accountability and responsibilities of the different levels of firm management with respect to partner management. The inspection team may interview members of the firm's management and review documentation related to certain of these topics. In addition, the inspection team's evaluation may include the results of interviews of audit partners regarding their responsibilities and allocation of time. Further, the inspection team may review a sample of partners' personnel files.

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

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

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

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

D.2.e. Review of a Firm's Processes for Monitoring Audit Performance, Including Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance, Independence Policies and Procedures, and Processes for Responding to Defects or Potential Defects in Quality Control

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

Procedures in this area are designed to identify and assess the monitoring processes that the firm uses to monitor audit quality for individual engagements and for the firm as a whole. The inspection team may interview members of the firm's management and review documents relating to the firm's identification and evaluation of, and response to, possible indicators of deficiencies in audit performance. In addition, the inspection team may review documents related to the design, operation, and evaluation of findings of the firm's internal inspection program, and may compare the results of its review of audit work to those from the internal inspection's review of the same audit work.

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

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

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

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

END OF PART I

PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

PART II

ISSUES RELATED TO QUALITY CONTROLS

This Part II contains a discussion of criticisms of and potential defects in the Firm's quality control system.[13] As described below, an analysis of the inspection results reported by the inspection team, including the results of the reviews of individual audits, * * * * indicates that the Firm's system of quality control requires remedial action in order to provide sufficient assurance that the Firm's audit work will meet applicable standards and requirements.

Concerns Related to the Tone at the Top

The Firm's inspection results have deteriorated over the past three years, even though the Firm has taken, and continues to take, steps intended to remediate quality control issues. The Firm has indicated, in communications with both the Board and the Firm's professionals, that a continued concentrated effort is required to address identified deficiencies. Certain of its actions and messaging, however, seem inconsistent with this premise. While multiple factors may have contributed to the negative trend in inspection results, it appears that the Firm's tone and messaging, in some respects, may present the risk of undercutting the Firm's specific efforts to remediate quality control concerns, in part because the tone and messaging may suggest a lack of complete commitment to an appropriately concentrated and objective approach to evaluating and responding to identified audit deficiencies and to addressing partners' audit quality. Continuing improvement in the Firm's tone at the top is important, as it is fundamental to the critical goal of achieving significant improvements in audit quality.

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[13] This report's description of quality control issues is based on the inspection team's observations during the primary inspection procedures. Any changes or improvements that the Firm may have made in its system of quality control since that time * * * * [have been] taken into account by the Board during its assessment of whether the Firm has satisfactorily addressed the quality control criticisms or defects within the twelve months after the issuance of this report.

In addition, the Firm's failure to implement a structured, documented process for assessing the audit quality of its partners,[14] other than when the partners are directly involved in negative inspection results or restatements, may suggest that the Firm is not as committed to promoting and rewarding good audit quality, and discouraging and addressing poor audit quality, as its formal communications may suggest. Further, the inconsistent involvement of senior Firm leaders in the auditing group in important aspects of dialogue with the inspection team may suggest to others in the Firm that these leaders have not prioritized the issues concerning audit quality that the dialogue involves.

Maintaining an appropriate tone is important to improving audit quality, as an appropriate (or inappropriate) tone and the behaviors of leadership can have a far-reaching effect on the Firm's culture and on its professionals, including how they view their role as auditors. * * * * Specifically, the Firm should assess whether the behaviors and actions of its leadership are consistent with, and supportive of, efforts to address identified deficiencies and to improve audit quality * * * *.

Deficiencies in the System of Quality Control Related to Testing Internal Control

The inspection results indicate that deficiencies exist in the Firm's system of quality control related to testing and evaluating internal control. Specifically, the inspection team identified deficiencies in the following areas: (1) selecting controls that address risks of material misstatement to the relevant assertions, [and] (2) testing the design and operating effectiveness of controls * * * *.

The 2014 inspection results show a significant increase in the number of identified deficiencies related to testing internal control, as compared to the 2013 inspection results, including a significant increase in the number of deficiencies that are of such significance that they are included in Part I.A of the inspection report. In 2014, the inspection team identified deficiencies in this area in 28 audits,[15] and deficiencies in

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[14] This matter is discussed in * * * * [Deficiencies in the Firm's Partner Evaluation Process], below.

[15] Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, R, S, T, U, V, W, X, Y, Z, AA, and CC

27 of these audits[16] are described in Part I.A of this report.[17] The high rate of observed deficiencies related to testing internal control is of significant concern, not only due to the severity and recurring nature of the deficiencies, but also because of the pervasive effect of internal control on the overall audit.

The deficiencies described below indicate that certain of the Firm's professionals may not have a sufficient understanding of PCAOB standards in this area. The deficiencies also indicate that some of the Firm's professionals do not perform procedures to identify and test controls with sufficient rigor, and that appropriate members of the engagement teams may not be devoting sufficient attention to supervising, including reviewing the results of, these procedures. In addition, some of the Firm's professionals may have allowed factors that are unrelated to the requirements of the auditing standards to affect the rigor with which they performed procedures, especially in circumstances where the preliminary audit results indicated that additional procedures were warranted, such as when * * * * the controls the Firm selected for testing did not address all the relevant risks * * * *.

Deficiencies Related to Selecting Controls that Address Risks of Material Misstatement to the Relevant Assertions

The Firm failed to identify and select for testing controls that sufficiently addressed the assessed risks of material misstatement to the relevant assertions in 12 audits.[18] In some of these audits, the failure occurred in areas where the Firm had identified fraud risks.

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16 Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, R, S, T, U, V, W, X, Y, Z, and AA

17 In 2013, the inspection team identified deficiencies related to testing internal control in * * * * 20 [audits] * * * * included in Part I.A of that report.

18 Issuers A, D, E, F, G, J, M, O, T, W, X, and Z

Deficiencies Related to Testing the Design and Operating Effectiveness of Controls

In 22 audits, the inspection team identified deficiencies related to testing the design and operating effectiveness of controls that the Firm selected for testing.[19] In some of these audits, the deficiencies involved the Firm's testing of controls that were intended to address identified fraud risks. In many of the 22 audits, the Firm failed to evaluate whether certain controls it selected operated at a level of precision to prevent or detect material misstatements. These deficiencies include failures to obtain an understanding of, and evaluate, the specific actions taken by the control owners, the criteria the control owners used to identify matters for investigation, and whether such matters were appropriately investigated and resolved.

In addition, in six of these audits,[20] the Firm failed to test, or to sufficiently test, controls over the completeness and/or accuracy of data and/or reports used in controls that the Firm tested.

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* * * * [T]he Firm should continue to perform its analyses of potential root causes of the deficiencies in these areas. These analyses should include consideration of whether the Firm's professionals have a sufficient understanding of PCAOB standards in these areas and whether engagement team leadership is providing appropriate supervision, including review, of tests of controls. The analyses should also specifically address whether additional guidance or training, enhancements to communications, or other changes to the Firm's system of quality control are necessary to provide reasonable assurance that the Firm's professionals will select and appropriately test controls that sufficiently respond to the risks of fraud that they identified. As a result of its analyses, the Firm should develop and implement appropriate remedial actions as necessary.

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[19] Issuers A, B, C, D, E, F, G, H, I, L, M, N, O, P, Q, R, S, U, V, Y, Z, and AA

[20] Issuers D, F, G, H, N, and O

Deficiencies in the System of Quality Control Related to Testing Accounting Estimates

The inspection results indicate that deficiencies exist in the Firm's system of quality control with respect to testing accounting estimates. Deficiencies related to testing various types of estimates, including the ALL, were also identified in prior years, including in 2013. The Firm's failure to perform sufficient procedures to evaluate significant assumptions underlying an estimate is a common element of many of the deficiencies in this area. The deficiencies related to testing estimates are a source of significant concern, not only due to their frequency and recurring nature, but also because the development of estimates can involve management's most complex and subjective judgments, and thus this area often involves significant risk. Effective testing of management's estimates requires the application of professional skepticism and often requires the involvement of the most senior members of the engagement team.

In 2014, the inspection team identified the deficiencies in the Firm's testing of estimates that are described below.

<u>Deficiencies in Testing the ALL</u>

The inspection results indicate deficiencies in the Firm's system of quality control with respect to testing the ALL. The inspection team reviewed the Firm's auditing of the ALL in twelve audits[21] and identified deficiencies in the testing of the ALL in seven of these audits,[22] each of which is included in Part I.A of this report. In each of these audits, the Firm failed to evaluate, or to sufficiently evaluate, the reasonableness of certain significant assumptions, including qualitative assumptions, that management used in developing its ALL estimates. In addition, in four of these seven audits,[23] the Firm determined that the issuer's

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21 Issuers A, C, E, H, K, L, P, Q, AA, BB, FF, and GG

22 Issuers A, C, E, H, L, P, and BB (With respect to issuers K and Q, the deficiencies in testing the ALL identified by the inspection team related only to sampling.)

23 Issuers A, E, H, and BB

assumptions or conclusions were reasonable without evaluating, or without sufficiently evaluating, all of the relevant evidence regardless of whether it appeared to corroborate or to contradict those assumptions or conclusions. Further, in three of these seven audits,[24] the Firm failed to test, or to sufficiently test, the accuracy and completeness of certain data that management used to develop its estimates.

The deficiencies in auditing the ALL that were identified in 2014 are similar to those included in prior inspection reports.[25] The 2014 inspection results continue to include a high rate of deficiencies in this area, and they indicate that further efforts are needed to improve the Firm's auditing of the ALL. The deficiencies indicate that some of the Firm's professionals may lack a sufficient understanding of how to apply PCAOB standards in this area. The deficiencies may also be caused by the failure by some of the Firm's professionals to appropriately apply professional skepticism, sometimes due to an over-reliance on perceived issuer expertise, and the failure to approach auditing this complex estimate with sufficient rigor. Some Firm professionals may have allowed concerns unrelated to the audit evidence and the requirements of the auditing standards to affect the rigor with which they performed audit procedures related to the ALL, especially in areas where they needed to challenge management's judgments and assumptions, such as in situations where the Firm identified information that was potentially inconsistent with the issuer's approach or assumptions.

In September 2014, the Firm implemented a monitoring program to perform pre-issuance[26] reviews, for certain audits, of the ALL testing and the effectiveness of a required work paper used by engagement teams to

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[24] Issuers E, H, and P

[25] Part I.A deficiencies were observed in nine * * * * audits in which the ALL was reviewed in 2013, one * * * * such audit * * * * in 2012, three * * * * such audits in 2011, and * * * * three such audits in 2010.

[26] These are reviews that are performed before the issuance of the Firm's audit opinion.

challenge the design of the issuer's ALL methodology. The Firm should assess the results of these reviews to evaluate what further actions are necessary with respect to the Firm's procedures for auditing the ALL.

In addition, the Firm should take steps designed to ensure that its professionals have an appropriate understanding of how to apply PCAOB standards in this area and that they approach the evaluation of the ALL and management's underlying assumptions with appropriate rigor and professional skepticism. These steps should include efforts designed to ensure that, when an engagement team's approach is to review and test management's process, the team's procedures include critically assessing the basis and support for the significant assumptions. The Firm also should continue to perform its analysis of potential root causes of the deficiencies in this area and, as a result of that analysis, develop and implement any additional remedial actions that are needed.

Deficiencies in Testing Estimates Other than the ALL

The inspection results indicate deficiencies in the Firm's system of quality control related to the testing of estimates other than the ALL. In nine audits,[27] four of which are included in Part I.A of this report,[28] the inspection team identified deficiencies in the Firm's testing of certain estimates other than the ALL. In all nine of these audits, the Firm failed to evaluate, or to sufficiently evaluate, the reasonableness of certain significant assumptions that management used in developing its estimates. In two of the nine audits, both of which are included in Part I.A of this report,[29] the Firm determined that the issuer's assumptions or conclusions were reasonable without sufficiently evaluating all of the relevant evidence regardless of whether it appeared to corroborate or to contradict those assumptions or conclusions. Also, in these

[27] Issuers A, C, G, M, N, W, X, DD, and EE

[28] Issuers A, C, G, and W

[29] Issuers C and G

same two audits, the Firm failed to test, or to sufficiently test, the accuracy and/or completeness of certain data that management used to develop its estimates.

These deficiencies may be caused by certain of the Firm's professionals' continued lack of a sufficient understanding of how to apply PCAOB standards in this area or by a failure to approach the auditing of management's estimates with sufficient rigor and professional skepticism.

The Firm should take steps designed to ensure that its professionals have an appropriate understanding of how to apply PCAOB standards in this area and that they approach with the necessary rigor and professional skepticism (1) the evaluation of the reasonableness of significant assumptions and (2) the testing of the accuracy and completeness of data that management used to develop significant estimates. The Firm also should continue to perform its analysis of potential root causes of the deficiencies in this area and, as a result of that analysis, develop and implement any additional remedial actions that are needed.

Deficiencies in the System of Quality Control Related to the Application of Professional Skepticism

The application of professional skepticism is essential to the performance of effective audits under PCAOB standards, and a lack of professional skepticism can have a pervasive effect on an audit. The inspection results indicate that the Firm's system of quality control appears not to provide reasonable assurance that the Firm's professionals will appropriately exercise professional skepticism in the performance of issuer audits.* * * *

In 2014, the inspection team identified deficiencies in 17 audits,[30] all of which are described in Part I.A of this report, that appear to be caused, at least in part, by the failure to appropriately exercise professional skepticism. Most of these deficiencies occurred when the Firm, when testing internal controls or significant assumptions used to develop accounting estimates, limited its procedures to, or relied heavily on, inquiry of management and review of issuer-prepared analyses or documentation that

[30] Issuers A, C, D, E, F, G, H, I, J, K, L, M, Q, R, V, AA, and BB

summarized transactions, procedures, or methods. In many of these audits, the Firm's failure to appropriately exercise professional skepticism occurred in areas where it had identified a significant risk, including a fraud risk in some instances. Further, in six of these 17 audits,[31] the Firm determined that the issuer's assumptions or conclusions were reasonable without evaluating, or without sufficiently evaluating, all of the relevant evidence regardless of whether it appeared to corroborate or to contradict those assumptions or conclusions.

Certain of these deficiencies may be due to some of the Firm's professionals lacking a sufficient appreciation of the requirement in PCAOB standards to exercise professional skepticism, or a lack of sufficient emphasis and specificity on this point in the Firm's guidance and training. In many instances, the Firm's professionals did not appear to understand that the application of professional skepticism is necessary when testing controls, and that simply determining that the control operated, relevant documentation was prepared, and data used in the control tied to the issuer's systems did not constitute an appropriate critical assessment of the effectiveness of the control. In addition, the deficiencies may stem, in part, from engagement teams seeking to gather and evaluate information that is consistent with management's judgments or representations, without critically assessing all of the relevant audit evidence, possibly due to concerns unrelated to the objective of performing a quality audit.

The Firm should continue its efforts to emphasize to its professionals the importance of exercising professional skepticism throughout the audit, and to provide that they have a sufficient understanding of how to appropriately apply professional skepticism, including by performing a critical assessment of the effectiveness of the controls they tested and of the evidence obtained through their substantive procedures. The Firm's efforts should also address the importance of the need for its professionals to perform procedures to address identified fraud risks and to sufficiently evaluate all of the relevant audit evidence, including evidence that may appear to contradict or be inconsistent with management's judgments or representations. Further, the Firm should continue to perform its analyses of potential root causes of the deficiencies in this area, including its efforts to identify the incidents in which its professionals failed to appropriately apply professional skepticism. As a result of those analyses, the Firm should develop and implement additional remedial actions.

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[31] Issuers A, C, E, G, H, and BB

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Deficiencies in the Firm's * * * * [In-flight Review Program]

The Firm's monitoring procedures include the Firm's * * * * in-flight review program. * * * * The in-flight review program includes the review, before the issuance of the audit report, of pre-determined areas of certain audits to assess the effectiveness of certain of the Firm's remedial actions related to identified deficiencies in the Firm's system of quality control, among other things. The inspection results indicate concerns about the effectiveness of the Firm's * * * * in-flight review program* * * *.

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> During 2014, the PCAOB inspection team inspected 19 audits[32] that had also been reviewed through the Firm's in-flight review program. In eight of these audits,[33] the PCAOB inspection team identified at least one Part I.A audit deficiency that the Firm's in-flight review had not detected, even though the in-flight reviewer had reviewed the same area. These results suggest that the in-flight review program is not operating effectively enough to achieve its objectives.
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> The in-flight reviews are conducted by partners and managers, many of whom have not received sufficient training, and may not have the appropriate perspective, related to the specific quality control deficiencies and the corrective actions that were implemented to address the deficiencies to accomplish the program's purpose of assessing the effectiveness of the corrective actions.
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> The Firm should evaluate whether the complement of reviewers is appropriate to drive consistent and effective execution of these reviews and whether the training provided is appropriate and sufficient to enable the reviewers to complete the reviews effectively. In addition, the Firm should

[32] Issuers B, D, F, K, L, N, S, V, Y, AA, FF, GG, JJ, KK, LL, MM, NN, OO, and PP

[33] Issuers B, D, F, K, L, S, Y, and AA

assess whether its process for appointing in-flight reviewers sufficiently considers the audit performance of the in-flight reviewers. The Firm also should perform its own analysis of potential root causes of the disparity between the PCAOB inspection results and the in-flight reviewers' findings and, as a result of that analysis, develop and implement any additional remedial actions that are necessary.

Deficiencies in the System of Quality Control Related to Engagement Supervision and Review

The inspection results indicate deficiencies in the Firm's system of quality control with respect to engagement supervision and review in two specific areas, which are described below. * * * *

Engagement Partner Supervision, Including Review

The 2014 inspection results show deficiencies in the supervision of audits, including review of audit work, by the Firm's engagement partners. In 24 audits,[34] all of which are described in Part I.A of this report, the inspection team identified deficiencies in an area of the audit for which the engagement team had identified a significant risk, including a fraud risk in some instances, and the engagement partner failed to identify and appropriately address the deficiencies.* * * *

These deficiencies suggest that some engagement partners may not be approaching their reviews with the professional skepticism necessary to perform a critical assessment of the audit approach and the audit evidence, particularly in audit areas requiring greater attention and judgment. These deficiencies also suggest that some engagement partners may not have a sufficient understanding of PCAOB standards. Further, these deficiencies indicate that certain of the Firm's engagement partners did not perform their reviews as thoroughly as necessary or devote sufficient time and attention to their reviews.

[34] Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, S, T, V, Y, Z, AA, and BB

The Firm should take steps designed to improve the rigor and effectiveness of engagement partner reviews, particularly in areas requiring greater attention and judgment. The Firm should assess whether audit engagement partners have a sufficient understanding of PCAOB standards for the particular audits supervised. In addition, the Firm should assess whether audit engagement partners' workloads, including time spent on audits and on other Firm responsibilities such as leadership roles, allow partners to have sufficient time to provide effective supervision of the issuer audits for which they are responsible, including by sufficiently reviewing the work of engagement team members. The Firm also should continue to perform its analyses of potential root causes of the inadequate supervision by certain of its engagement partners, and it should implement corrective actions as necessary.

Engagement Quality Review

The 2014 inspection results show deficiencies in the Firm's engagement quality reviews. In 14 of the 24 audits discussed above,[35] the EQCR partner either failed to identify a deficiency in an area of significant risk, including in some cases a fraud risk, or he or she failed to pursue the matter sufficiently. * * * * These deficiencies indicate that certain of the Firm's EQCR partners did not perform their reviews as thoroughly as necessary, possess the requisite skills, or devote sufficient time and attention to their reviews.

The Firm should take steps designed to improve the rigor and effectiveness of the engagement quality reviews. The Firm should assess whether EQCR partners appropriately apply skepticism in their reviews and possess adequate skills for the particular audits reviewed. In addition, the Firm should assess whether excessive workloads or time constraints, or the manner in which related audit documentation is assembled and presented to the EQCR partner, may be contributing to the inadequate reviews. The Firm also should perform its own analysis of potential root causes of the inadequate review by certain of its EQCR partners. The Firm should implement corrective actions as necessary.

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[35] Issuers A, C, D, G, J, L, M, O, S, T, V, Y, Z, and BB

Deficiencies in the Firm's Partner Evaluation Process

The inspection results indicate that deficiencies exist in the Firm's system of quality control related to its partner evaluation process ("PEP") in the following respects –

* * * *

Accountability for Other Partners Involved in Issuer Audits

> As part of its PEP, the Firm requires consideration of whether [negative audit quality incidents] [(")NAQIs(")] related to issuer audits should be attributed to other partners, beyond the lead audit engagement partner, EQCR, and other partners assigned to the audit, who were involved with an issuer audit, such as business unit, regional, industry, and national office leaders. For its 2014 fiscal year, the Firm determined that no NAQIs should be attributed to any business unit, regional, industry, and/or national office leader. The Firm, however, did not document the rationale for its determination regarding any of these individuals with respect to any of the NAQIs considered during the year.

As a result of the above, * * * * the Firm's actions may suggest that audit quality is not a shared responsibility, with attendant consequences, of all those with authority and involvement in the conduct of audits. A result of these circumstances could be that audit partners may not consider audit quality to be of the critical importance that the Firm accords it in its overall messaging.

* * * * [T]he Firm should evaluate the effectiveness of its PEP process, including whether that process adequately addresses whether partners beyond those on the engagement team are held accountable, when appropriate, for NAQIs on audits with respect to which they have some responsibility. As a result of this evaluation, the Firm should develop and implement appropriate remedial actions to address the concerns in this area.

* * * *

PCAOB Standards

The table below lists the specific PCAOB standards that are primarily related to the descriptions of defects in, or criticisms of, the Firm's system of quality control included in this Part of the report.[36]

PCAOB Standards
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
AS No. 7, *Engagement Quality Review*
AS No. 10, *Supervision of the Audit Engagement*
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
AS No. 14, *Evaluating Audit Results*
AU 230, *Due Professional Care in the Performance of Work*
* * * *
AU 328, *Auditing Fair Value Measurements and Disclosures*
* * * *
AU 342, *Auditing Accounting Estimates*
* * * *
QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*
QC 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*
QC 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-In-Charge of an Attest Engagement*

* * * *

[36] This table does not necessarily include reference to every standard that may have been related to the criticisms or potential defects that are included in Part II.

APPENDIX C

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.[37]

[37] The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

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October 1, 2015

Ms. Helen A. Munter
Director – Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Dear Ms. Munter:

We are pleased to provide our response to Part I of the Public Company Accounting Oversight Board's ("PCAOB") Draft Report on 2014 Inspection of KPMG LLP dated August 31, 2014 ("Draft Report").

Consistently executing high-quality audits is our top priority. We take the findings from the PCAOB inspection process seriously and believe the inspection process serves to assist us in identifying areas where we can continue to improve our performance and strengthen our system of audit quality control. We remain committed to full cooperation with the PCAOB, appreciate the professionalism and commitment of the PCAOB staff and value the important role the PCAOB plays in improving audit quality.

We conducted a thorough evaluation of the matters identified in Part I of the Draft Report and have taken appropriate actions to address the engagement-specific findings in a manner consistent with PCAOB auditing standards and KPMG policies and procedures.

We remain dedicated to evaluating and improving our system of audit quality control, including monitoring audit quality and implementing changes to our policies and practices in order to enhance audit quality. We understand our responsibility to investors and other participants in the capital markets and are committed to continuing to work constructively with the PCAOB to improve audit quality and build confidence in the auditing profession.

Very truly yours,

KPMG LLP

Lynne M. Doughtie
Chairman and Chief Executive Officer

Scott M. Marcello
Vice Chair – Audit

APPENDIX D

AUDITING STANDARDS REFERENCED IN PART I

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

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
PLANNING THE AUDIT		
Addressing the Risk of Fraud		
AS No. 5.14	When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include - ▪ Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries; ▪ Controls over journal entries and adjustments made in the period-end financial reporting process; ▪ Controls over related party transactions; ▪ Controls related to significant management	Issuer O

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	estimates; and ▪ Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.	
Footnote to AS No. 5.14 [10/] See Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* regarding identifying risks that may result in material misstatement due to fraud		
Using the Work of Others		
AS No. 5.19	The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.	Issuers A, H, and O
USING A TOP-DOWN APPROACH		
Selecting Controls to Test		
AS No. 5.39	The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.	Issuers A, C, D, E, F, G, H, J, M, N, O, T, W, X, and Z
TESTING CONTROLS		
Testing Design Effectiveness		
AS No. 5.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.	Issuers A, C, D, E, F, G, H, L, M, U, V, Y, Z, and AA

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of 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.	
Testing Operating Effectiveness		
AS No. 5.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	Issuers A, B, C, D, E, F, G, H, K, L, M, N, P, Q, U, V, Y, Z, and AA
Relationship of Risk to the Evidence to be Obtained		
AS No. 5.46	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.	Issuer C

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	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.	
AS No. 5.48	When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.	Issuer M
EVALUATING IDENTIFIED DEFICIENCIES		
AS No. 5.62	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 A
AS No. 5.63	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	Issuer A

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	or disclosure; and • The magnitude of the potential misstatement resulting from the deficiency or deficiencies.	
AS No. 5.68	The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.	Issuers A, C, D, and S
APPENDIX B - Special Topics		
INTEGRATION OF AUDITS		
AS No. 5.B8	*Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum – • The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud. • 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 C
MULTIPLE LOCATIONS SCOPING DECISIONS		
AS No. 5.B10	In determining the locations or business units at	Issuers B and I

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk. Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.	
USE OF SERVICE ORGANIZATIONS		
AS No. 5.B24	When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.	Issuer R
AS No. 5.B25	The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for	Issuer R

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	the auditor to obtain additional evidence increases. ▪ The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, ▪ The significance of the activities of the service organization, ▪ Whether there are errors that have been identified in the service organization's processing, and ▪ The nature and significance of any changes in the service organization's controls identified by management or the auditor.	

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
Responses Involving the Nature, Timing, and Extent of Audit Procedures		
AS No. 13.8	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers A, D, J, and N
RESPONSES TO FRAUD RISKS		
AS No. 13.13	*Addressing Fraud Risks in the Audit of Financial Statements*. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.	Issuers M, O, and BB
Testing Controls		
TESTING CONTROLS IN		

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
AN AUDIT OF FINANCIAL STATEMENTS		
AS No. 13.16	*Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.	Issuers B, C, F, K, O, and Q
Footnotes to AS No. 13.16 [12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures. [13/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.		
AS No. 13.18	*Evidence about the Effectiveness of Controls in the Audit of Financial Statements*. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.	Issuers B, C, F, K, O, and Q
ASSESSING CONTROL RISK		
AS No. 13.34	When deficiencies affecting the controls on which	Issuer O

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
	the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should: a. Perform tests of other controls related to the same assertion as the ineffective controls, or b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk. Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.	
Substantive Procedures		
AS No. 13.37	As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.	Issuers B, C, F, K, O, and Q
TIMING OF SUBSTANTIVE PROCEDURES		
AS No. 13.46	If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the	Issuer A

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
	related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.	

AS No. 14, *Evaluating Audit Results*		
Evaluating the Results of the Audit of Financial Statements		
AS No. 14.3	In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.	Issuers E, G, and H

AS No. 15, *Audit Evidence*		
Sufficient Appropriate Audit Evidence		
USING INFORMATION PRODUCED BY THE COMPANY		
AS No. 15.10	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 D, F, H and N
<u>Footnote to AS No. 15.10</u>		

AS No. 15, *Audit Evidence*
[3/] When using the work of a specialist engaged or employed by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, see Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
Responding to Assessed Fraud Risks		
Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls		
AU 316.58	***Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.*** Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (a) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements. More specifically, the auditor should: 1. Obtain an understanding of the entity's financial reporting process [fn23] and the controls over journal entries and other adjustments. (See paragraphs .59 and .60.) 2. Identify and select journal entries and other adjustments for testing. (See paragraph .61.) 3. Determine the timing of the testing. (See paragraph .62.)	Issuer O

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	4. Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.	
<u>Footnote to AU 316.58</u> fn 23 See paragraphs 28 through 32 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.		
AU 316.60	An entity may have implemented specific controls over journal entries and other adjustments. For example, an entity may use journal entries that are preformatted with account numbers and specific user approval criteria, and may have automated controls to generate an exception report for any entries that were unsuccessfully proposed for recording or entries that were recorded and processed outside of established parameters. The auditor should obtain an understanding of the design of such controls over journal entries and other adjustments and determine whether they are suitably designed and have been placed in operation.	Issuer D
AU 316.61	The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider: • The auditor's assessment of the fraud risk. The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary. • The effectiveness of controls that have been implemented over journal entries and other adjustments. Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented	Issuer D

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items. • The entity's financial reporting process and the nature of the evidence that can be examined. The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested. • The characteristics of fraudulent entries or adjustments. Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make	

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or a consistent ending number. • The nature and complexity of the accounts. Inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to errors in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain intercompany transactions, or (f) are otherwise associated with an identified fraud risk. In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, Audit Planning. • Journal entries or other adjustments processed outside the normal course of business. Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity's internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments such as consolidating adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity's internal controls. Accordingly,	

AU 316, *Consideration of Fraud in a Financial Statement Audit*		
	the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.	

AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*		
Extent of the Effect of the Internal Auditors' Work		
AU 322.20	In making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor considers— *a.* The materiality of financial statement amounts—that is, account balances or classes of transactions. *b.* The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to these financial statement amounts. c. The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions.[fn 7] As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.	Issuers A, H, and O
<u>Footnote to AU 322.20</u> [fn 7] For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions.		
AU 322.21	For assertions related to material financial	Issuers A, H,

AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*		
	statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.	and O

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Testing The Entity's Fair Value Measurements and Disclosures		
AU 328.23	Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs .26 through .39), (*b*) developing independent fair value estimates for corroborative purposes (see paragraph .40), or (*c*) reviewing subsequent events and transactions (see paragraphs .41 and .42).	Issuer A

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AU 328.26	The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06). b. The fair value measurement was determined using an appropriate model, if applicable. c. Management used relevant information that was reasonably available at the time.	Issuers A and G
AU 328.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.	Issuers A and G
AU 328.31	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 A and G
AU 328.36	To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),[fn 5] individually and taken as a whole, need to be realistic and consistent with: a. The general economic environment, the economic	Issuer G

AU 328, *Auditing Fair Value Measurements and Disclosures*

	environment of the specific industry, and the entity's economic circumstances; b. Existing market information; c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies; d. Assumptions made in prior periods, if appropriate; e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable; f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and g. The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate. Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.	
Footnote to AU 328.36 fn 5 The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).		
Developing Independent Fair Value Estimates for Corroborative Purposes		
AU 328.40	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.[fn 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	Issuer A

AU 328, *Auditing Fair Value Measurements and Disclosures*		
	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.	
Footnote to AU 328.40 fn 6 See section 329, *Analytical Procedures*.		

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

AU 329, *Substantive Analytical Procedures*		
Analytical Procedures Used as Substantive Tests		
Plausibility and Predictability of the Relationship		
AU 329.13	It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.	Issuers B and F
AU 329.14	As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.	Issuers B and F
Investigation and Evaluation of Significant Differences		
AU 329.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, Evaluating	Issuer F

AU 329, *Substantive Analytical Procedures*		
	Audit Results.)	

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

AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*		
Designing Substantive Procedures Based on Risk Assessments		
Financial Statement Assertions		
Completeness		
AU 332.22	Completeness assertions address whether all of the entity's derivatives and securities are reported in the financial statements through recognition or disclosure. They also address whether all derivatives and securities transactions are reported in the financial statements as a part of earnings, other comprehensive income, or cash flows or through disclosure. The extent of substantive procedures for completeness may properly vary in relation to the assessed level of control risk. In addition, the auditor should consider that since derivatives may not involve an initial exchange of tangible consideration, it may be difficult to limit audit risk for assertions about the completeness of derivatives to an acceptable level with an assessed level of control risk at the maximum. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for completeness assertions about derivatives and securities are— • Requesting the counterparty to a derivative or the holder of a security to provide information about it, such as whether there are any side agreements or agreements to repurchase securities sold. • Requesting counterparties or holders who are frequently used, but with whom the accounting records indicate there are presently no derivatives or securities, to state whether they are counterparties to derivatives with the entity or holders of its securities. [fn 13] • Inspecting financial instruments and other agreements to identify embedded derivatives. • Inspecting documentation in paper or electronic form for activity subsequent to the end of the reporting period. • Performing analytical procedures. For example,	Issuers A and E

AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*		
	a difference from an expectation that interest expense is a fixed percentage of a note based on the interest provisions of the underlying agreement may indicate the existence of an interest rate swap agreement. • Comparing previous and current account detail to identify assets that have been removed from the accounts and testing those items further to determine that the criteria for sales treatment have been met. • Reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees.	
Footnote to AU 332.22 fn 13 Section 330.17 discusses the blank form of positive confirmation in which the auditor does not state the amount or other information but instead asks the respondent to provide information.		
AU 332.23	One of the characteristics of derivatives is that they may involve only a commitment to perform under a contract and not an initial exchange of tangible consideration. Therefore, auditors designing tests related to the completeness assertion should not focus exclusively on evidence relating to cash receipts and disbursements. When testing for completeness, auditors should consider making inquiries, inspecting agreements, and reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees. Auditors should also consider making inquiries about aspects of operating activities that might present risks hedged using derivatives. For example, if the entity conducts business with foreign entities, the auditor should inquire about any arrangements the entity has made for purchasing foreign currency. Similarly, if an entity is in an industry in which commodity contracts are common, the auditor should inquire about any commodity contracts with fixed prices that run for unusual durations or involve unusually large quantities. The auditor also should consider inquiring as to whether the entity has converted interest-bearing debt from fixed to variable, or vice versa, using derivatives.	Issuers A and E

AU 342, *Auditing Accounting Estimates*		
Evaluating Accounting Estimates		
Evaluating Reasonableness		
AU 342.11	Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach: a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests. c. Consider whether there are additional key factors or alternative assumptions about the factors. d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose. f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions. g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the	Issuers A, C, E, G, H, L, P, W, and BB

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

AU 350, *Audit Sampling*		
Sampling In Substantive Tests Of Details		
Planning Samples		
AU 350.19	The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.[fn 3] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	Issuers C, F, H, K, O, and Q
Footnote to AU 350.19 [fn 3] Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.		
AU 350.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor	Issuers C, F, H, K, O, and

AU 350, *Audit Sampling*		
	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.	Q
AU 350.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuers C, F, H, K, O, and Q