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# Report on

# 2003 Limited Inspection of Deloitte & Touche LLP

**Issued by the**

## Public Company Accounting Oversight Board

**August 26, 2004**

**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. 104-2004-002

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## Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.

2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the regulatory supervisory context in which this report was prepared. Discussions of the Board's or Board staff's views on such matters are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.

3. In connection with inspections of registered public accounting firms, the Board and its staff consider whether the firm, in its audits of financial statements, has failed to identify departures from Generally Accepted Accounting Principles (GAAP). This report's descriptions of such failures necessarily involve descriptions of the Board and Board staff's view of the relevant GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

4. The audit engagements reviewed during this limited inspection concerned financial statements for periods that ended before the relevant standards (then referred to as Generally Accepted Auditing Standards or "GAAS") were adopted by the PCAOB on an interim basis as the PCAOB standards that, under the Act, now govern the audits of the financial statements of issuers. For consistency with the Board's approach to this issue in other contexts, this inspection report refers to the applicable standards as PCAOB standards even with respect to periods before the Board adopted the standards. *Cf.* Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board, PCAOB Release No. 2003-025 (Dec. 17, 2003) (approved by the Commission, May 14, 2004).

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## INSPECTION REPORT OVERVIEW

In 2003, the Public Company Accounting Oversight Board conducted inspections of public accounting firms for the first time. The Board inaugurated its inspection program with limited inspections of the four largest U.S. public accounting firms, including Deloitte & Touche LLP, the subject of this report. In those inspections, the Board identified significant audit and accounting issues that were missed by the firms, and identified concerns about significant aspects of each firm's quality controls systems. The Board's inspection reports describe those issues. Because Board inspections and inspection reports are new, however, the Board offers a few remarks by way of providing readers with a context for the observations described in this report.

The Board's statutorily prescribed mission is to oversee auditors of public companies in order to protect the interests of investors and to further the public interest in the preparation of informative, fair, and independent audit reports. To advance that mission, Board inspections take up the basic task that had been the province of the accounting profession's peer review system, but Board inspections do not duplicate the programs and approach of peer review.

Board inspections do, of course, examine technical compliance with professional accounting and auditing standards, but Board inspections also examine the business context in which audits are performed, and the ways in which that context influences firm audit practices. Among other things, the Board looks at firm culture, the relationships between a firm's audit practice and its other practices, and the relationship between a firm's national office and its engagement personnel in field and affiliate offices. Through this approach, the Board believes that it can help bring about constructive change in the types of practices that contributed to the most serious financial reporting and auditing failures of the last few years.

Toward that end, an essential ingredient of the Board inspection process is an unflinching candor with firms about the points on which we see a need for improvement. That emphasis may often result in inspection reports that appear to be laden with criticism of a firm's policies, practices, and audit performance, and less concerned with a recitation of a firm's strengths. That is because, from the Board's perspective, the inspection reports are not intended to serve as balanced report cards, rating tools, or potential marketing aids for any firm. The reports are intended principally to focus our inspection-related dialogue with a firm on those areas where improvement is either required for compliance with relevant standards and rules, or is likely to enhance the quality of the firm's audit practice.

The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspected in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.

Moreover, the Board does not doubt that the bulk of the firms' audit professionals consists of skillful and dedicated accountants who strive – at times against the competing priorities of the large and complex business of the firms – to make audit quality their top priority. The Board is encouraged by the increasing tendency of persons at the highest levels of the firms to speak of the need for a renewed commitment to audit quality as the firm's top priority. The Board is also encouraged by the firms' recognition of the value of the Board's inspection process. The Board will continue to use its inspection authority to focus the firms on aspects of their practice that may stand as an impediment to the highest quality audit performance.

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PCAOB Release No. 104-2004-002

# 2003 LIMITED INSPECTION OF DELOITTE & TOUCHE LLP

In 2003, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted a limited inspection of Deloitte & Touche LLP ("Deloitte"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part III of the report. Part III of the report consists of the firm's comments on a draft of the report.[1/]

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.[2/] A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

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1/ The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change in the report.

2/ See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

## PART I

## INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's Inspection staff ("the staff") performed a limited inspection of Deloitte during the period from June 2003 through December 2003. The staff performed field work at Deloitte's national office and at four of its practice offices. The staff also observed and tested aspects of Deloitte's internal inspection program at two additional practice offices.

The limited inspection included a review of certain portions of selected audit engagements and a review of policies and procedures in the following seven functional areas, which were selected based on criteria identified by the Board:

- Tone at the top;
- Practices for partner evaluation, compensation, promotion, and assignment of responsibility;
- Independence implications of non-audit services; business ventures, alliances and arrangements; and commissions and contingent fees;
- Client acceptance and retention;
- The firm's internal inspection program;
- Practices for establishment and communication of audit policies, procedures and methodologies, including training; and
- The supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. audit clients.

Part I.A below provides a description of the steps that the staff took with respect to the review of audit engagements and the review of the seven functional areas. Following that, Part I.B describes, at a general level, certain observations concerning Deloitte's audit performance as observed in the review of audit engagements. The public portion of this report then concludes with certain general observations in Part I.C.

## A. The Inspection Process

The staff carried out extensive procedures related to Deloitte's public company audit practice. Even so, the Board emphasizes the limited nature of this initial inspection of Deloitte compared to the scope of the inspections that we intend to conduct for large firms as we go forward. Although the practical considerations in creating a new inspection program (including the time required to enlist a sufficient number of appropriately skilled staff) prevented the Board from conducting full-scale inspections in 2003, the Board determined that conducting limited inspections was feasible and would advance the public interest by providing a foundation for the full-scale inspections to come.

### 1. Review of Selected Audit Engagements

At the outset of the inspection, the staff selected 16 audit engagements to review. The staff chose the engagements according to the Board's own criteria. As with any Board inspection, Deloitte was not allowed an opportunity to limit or to influence the selection process.

For its engagement reviews, the staff selected certain subject matters for review, such as: revenues, reserves or estimated liabilities, related party transactions, supervision of work performed by foreign affiliates, the assessment of risk by the audit team, and journal entries and adjustments. The staff also analyzed potential adjustments to the issuer client's financial statements that had been identified during the audit but not recorded in the financial statements. While at the practice offices, the staff also interviewed, by phone, the chair of each issuer's audit committee and reviewed communications between the firm and the audit committee.

When the staff identified a potential issue, the staff spoke with members of the audit engagement team. If the staff was unable to resolve the issue through this discussion and any resultant review of additional work papers or other documentation, the staff ordinarily requested the engagement team to consult with Deloitte's professional practice personnel, who include local office professional practice directors ("PPDs"), regional professional practice directors ("RPPDs") and members of the national office professional practice group. In many cases, this consultation process resulted in resolution of the matter, either because Deloitte agreed with the position the staff had taken and the firm or the issuer took adequate steps, in light of the significance of the error, to remedy the exception, or because Deloitte was able to provide additional information that effectively addressed the staff's concerns.

2. Review of Seven Functional Areas

The staff conducted the procedures related to the review of these areas primarily at Deloitte's national offices in Wilton, CT and New York City (together, "National Office"), but while at the four practice offices, the staff also performed procedures relating to six of the functional areas listed above.[3/] At the National Office, the staff interviewed numerous members of the firm's leadership; read and evaluated extensive documentation of firm policies and procedures; analyzed other source documents (including a sample of partners' personnel files) relating to the functional areas inspected; and reviewed communications from the National Office to firm personnel.

At the practice offices, the staff interviewed office leadership, partners and managers and reviewed relevant documentation. The staff also conducted focus group sessions of staff, outside the presence of office leadership and on a not-for-attribution basis. The staff conducted separate group sessions for audit managers and for senior accountants/staff. In these groups, the staff facilitated discussion by the participants of their understanding of the messages conveyed by firm and office leadership and other personnel, and how these messages might affect the participants' actions, as well as their views on the functional areas. The review of the seven functional areas will be used to provide a knowledge base upon which to draw in planning inspections, comparing firm practices, and measuring and evaluating progress by, or deterioration of, Deloitte over time.

Naturally, each of the functional areas reviewed involved a scope of materials and procedures particular to it. A more detailed description of the scope with respect to each of the seven functional areas is set out below.

*a. Review of Tone at the Top*

The primary objective of the review of the firm's "tone at the top" was to assess whether actions and communications by the firm's leadership demonstrate a commitment to audit quality and compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the SEC, and professional standards in connection with the firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the staff read, reviewed and analyzed the following information at the National Office:

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[3/] The functional area not specifically reviewed at the practice offices is the establishment and communication of audit policies, procedures and methodologies, including training.

- The firm's code of conduct;

- Organizational charts, descriptions of the duties of the board and biographies of board members;

- A description of the reporting relationship of Deloitte's top technical partner to its CEO;

- Ten public company audit proposals;

- The most recent client and audit committee survey used to evaluate client managements' or audit committees' satisfaction with services provided by the firm;

- The most recent internal professional staff survey used to evaluate Deloitte staff's views on tone at the top, training and education, people development, hiring and staffing, compensation and performance evaluations;

- The "client service model," which includes a summary of the roles and responsibilities of each engagement team member;

- Policies and procedures for evaluation of partner performance, partner compensation, nomination and admission of new partners, assignment of duties, termination and reassignment, and measures used by management for monitoring partner activities;

- Policies and procedures for the measurement and monitoring of audit quality for individual engagements and partners;

- The most recent policies and procedures for accepting prospective public company clients, including those non-public companies that are likely IPO candidates, and continuance of existing public company clients;

- The strategic business plans of the firm and of each line of service of the firm;

- Documentation showing the financing structure of the firm;

- Internal publications and internal communications;

- Presentations and speeches by senior firm leadership;
- The agendas and minutes of meetings of the board of directors; and
- The agendas for the executive committee meetings.

In addition, the staff interviewed 20 members of the firm's leadership team.

The staff also performed procedures at each of the four practice offices. The staff interviewed the practice office leadership, including the managing partners, audit partners-in-charge ("PIC"), PPDs, and selected audit business and professional leaders. In addition, the staff interviewed several audit partners and managers on the 16 engagements reviewed to obtain their perspectives on messages and communications from the firm's leadership related to audit quality and the tone at the top.

At each of the four practice offices, the staff also conducted two separate focus group meetings with six to 10 audit senior managers or managers and six to 10 audit senior accountants or staff. The purpose of the focus group meetings was to assess the participants' understanding of, among other things, the messages conveyed by firm leadership, office leadership and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top.

*b. Review of Partner Evaluation, Compensation, Promotion, and Assignment of Responsibility*

The objectives of the inspection procedures in this area were to assess the firm's current policies and procedures for evaluating partner performance and determining partner compensation; to determine the relative weight the firm gives to marketing as opposed to audit quality and technical competence in admitting new partners, measuring partner performance, establishing partner compensation, assigning responsibilities to partners, and disciplining partners; and to evaluate whether the design of the measurement, evaluation and compensation processes as documented and communicated could be expected to achieve the objective of promoting audit quality. Toward those ends, the staff read, reviewed and analyzed the firm's policies and procedures related to the following:

- Evaluation of partner performance;
- Determination of partner compensation;

- Process for nomination and admission of new partners; and

- Discipline, assignment of duties, and termination or re-assignment of partners.

The staff also –

- Reviewed schedules and supporting documents that included each partner's name, office location, assigned management responsibilities (other than engagement responsibilities), years as a partner, overall partner evaluation, age, amount of the prior year's units allocation, and other information;

- Reviewed a schedule of personnel considered for partnership admission but not admitted in the current year;

- Selected a sample of 25 partners and reviewed each partner's personnel file and the documentation therein of the factors used by the firm in establishing the partner's compensation;

- Selected a sample of 25 newly admitted partners, 15 direct partner admissions, and 15 individuals who were considered for admission to the partnership, but were not admitted, and reviewed the stated rationale for the decision to admit or not admit;

- Selected a sample of 25 partners who resigned, were terminated or took early retirement during the year and reviewed the stated rationale for the action;

- Interviewed members of Deloitte's board of directors, the U.S. CEO of Deloitte, the U.S. Managing Partner, the National Managing Partner – Audit and Enterprise Risk Services ("AERS"), the National Director – U.S. Practice Review, the National Managing Director – Human Resources, the CFO, major service line leaders, and the National Managing Partner – Risk, Professional and Regulatory Matters in order to understand the process of compensating partners.

The staff's procedures at the four practice offices included:

- Interviews with the lead audit partner of each issuer client engagement reviewed and, in certain instances, one of the other partners assigned to that engagement to determine how partners allocate their time during the year (*e.g.*, to performing audits, to maintaining client relationships, to sales or marketing activities, or to training, coaching and recruiting personnel); the effects partner compensation policies have on that allocation; and the relative effects the partners believe audit quality, selling, and technical competence have on their compensation, evaluation, and advancement within the partner ranks. Furthermore, the staff reviewed personnel files of these partners to determine whether their prior evaluations support their assignment to the audit engagements being inspected; and

- Interviews with local or regional leadership, including the local or regional managing partners, the audit PICs and the PPDs regarding the new partner admission process, the performance of the engagement partners the staff interviewed and that of any senior managers who were considered for admission but were not admitted, any disciplinary actions taken, and any situations where a client requested a change in the partner assigned to its audit.

*c. Review of Independence Policies*

The objectives of the inspection procedures in this area included gaining an understanding of certain Deloitte policies and procedures relating to the firm's compliance with independence requirements. In particular, the staff focused on independence issues related to the provision of non-audit services to issuer clients and concerning the firm's business ventures, alliances, and arrangements. The staff also focused on the firm's internal processes for monitoring compliance with those policies. To accomplish these objectives, the staff reviewed the firm's policies, procedural guidance and training materials pertaining to independence matters. The staff –

- Reviewed policies, procedures, guidance materials, and practice aids related to independence (including independence consultations) for non-audit services to audit clients by service line;

- Reviewed a description of the processes for establishing an alliance and making venture capital investments;

- Reviewed a description of the procedures for independence consultations;

- Reviewed materials for training programs on independence;

- Reviewed documentation of Deloitte's internal inspection program as it relates to monitoring compliance with Deloitte's independence policies and procedures;

- Interviewed numerous National Office and practice office personnel;

- Selected and reviewed a sample of 25 independence consultations from Deloitte's independence consultation log; and

- Reviewed listings of Deloitte's known business ventures, alliances, and arrangements, along with a description of the nature and purpose of each.

For each of the 16 engagements selected for review, the staff reviewed relevant information to identify any non-audit services performed for the issuer, as well as any business ventures, alliances, or arrangements with the issuer; and to determine whether the fees for the services provided are classified appropriately in the issuer's proxy statement. In addition, the staff read and evaluated the most recent letter pursuant to Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

*d. Review of Client Acceptance and Retention Policies*

The primary objective of the inspection procedures in this area was to evaluate whether the firm's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity. A firm should undertake only engagements within its professional competence and should appropriately consider the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the staff read, reviewed and analyzed the following information at the National Office:

- Policies and procedures for acceptance of prospective audit clients, and continuance of existing audit clients;

- The forms used in the acceptance and continuance processes;

- A list of all issuer audit clients accepted by the firm during the period August 2002 to July 2003, including each issuer's name, the affected office, the predecessor audit firm, whether the change involved any of the situations described in Item 304(a)(1)(v) of SEC

Regulation S-K, and whether the predecessor audit firm was dismissed or resigned;

- A list of all issuer audit clients that had changed from Deloitte to other auditors during the period August 2002 to July 2003, and for each such former client, a copy of the Form 8-K and the related SECPS letter.

The staff also –

- Read and evaluated 20 client acceptance packages for completion and approval in accordance with firm policies;

- Reviewed the documentation related to 22 "lost clients" for compliance with the firm's policies and procedures and professional and regulatory requirements;

- Interviewed members of the board of directors, the U.S. CEO of Deloitte, the CFO, the U.S. Managing Partner, major service line leaders and the National Director – Quality Assurance to obtain an understanding of the client acceptance and continuance practices and procedures.

At the four practice offices, the staff –

- Reviewed client continuance documentation for the 16 issuers selected for review and evaluated whether the documentation was completed and approved in accordance with firm policies;

- Interviewed the audit engagement partners and managers on these 16 engagements concerning the reasons for continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks;

- For the 16 engagements, evaluated whether the audit planning documentation incorporated the specific actions, if any, developed in response to any identified risks and addressed the impact of any such identified risks upon the audit scope for the next audit cycle.

*e. Review of Internal Inspection Program*

The objectives of the inspection procedures in this area were to evaluate the effectiveness of the firm's annual internal inspection program in enhancing audit quality, including evaluating the results and the remedial actions taken, and to observe and test the conduct of the internal inspection program in two practice offices to assess compliance with the quality control standards adopted by the Board.

The staff read, reviewed and analyzed the following information at the National Office:

- Policies and procedures for the internal inspection program, including the program's goals and objectives, and the methods of selection of offices, partners, engagements and functional areas to be reviewed;

- The internal inspection reviewer instructions, engagement profile information forms used in the selection process, the engagement review questionnaire and review summary, industry supplements, and a copy of the issue sheets used to document findings by the reviewer;

- Focus group discussion instructions including discussion topics and questions;

- Results of the current year's internal inspection program, the reviewers' findings, and the firm's evaluation of the results; and

- Communications of the 2003 internal inspection program results to the firm's senior management and to partners and professional staff.

Further, the staff conducted interviews with the partner in charge of the internal inspection program and gained an understanding of the program and process. The staff also interviewed members of the board of directors, the U.S. CEO of Deloitte, the U.S. Managing Partner, the National Managing Partner – AERS, the National Managing Partner – Risk, Professional and Regulatory Matters, the National Director – Quality Assurance, the CFO and major service line leaders. In the practice offices, the staff interviewed the area leadership, including the office managing partners, PPDs, and audit PICs. The staff also interviewed the partners and managers on the 16 engagements reviewed regarding the internal inspection program, the process and its effectiveness.

The staff reviewed and tested the conduct of the internal inspection program in one region, carried out in two offices, and performed the following procedures:

- Reviewed and evaluated the qualifications and experience of the firm's inspectors;

- Reviewed four of the 13 engagements reviewed by Deloitte, including performing the following procedures in each review:

    - Read the issuer's financial statements and the firm's audit report;

    - Read the engagement team's overall summary memorandum;

    - Discussed the internal inspection with the review team;

    - Reviewed the engagement team's work papers for several areas;

    - Read the reviewer's comments, engagement review questionnaires (and industry supplements, when applicable) and other documentation of the review that the firm's internal inspectors had prepared;

    - Attended (either in person or by phone) the closing meeting between the engagement team and the review team; and

    - Compared the staff's findings with those of the review team, and discussed and followed up with the firm regarding any significant differences.

- Read the reviewers' comments for the region's internal inspection review;

- Reviewed the results of the internal inspection team's review of the functional areas (for example, human resources, independence, consultation policy awareness, and client acceptance and retention);

- Attended the focus group discussions held with the managers and seniors/staff in one office; and

- Attended and observed the region's internal inspection closing conference.

### *f. Review of Practices for Establishment and Communication of Audit Policies, Procedures and Methodologies, Including Training*

The objectives of the procedures in this area were to obtain an understanding of the firm's processes for establishing and communicating audit policies, procedures and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; to evaluate changes in audit policy the firm has made; and to evaluate the content of the firm's training on the recently issued Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* ("SAS 99").

The staff read and analyzed the following information at the National Office:

- A memorandum explaining how the firm develops and revises its policies and procedures;

- Lists of the changes made to the firm's Web-based policy and procedure manual from September 6, 2002 through September 12, 2003;

- Internal guidance distributed to audit personnel for recent changes to accounting and auditing literature and regulatory requirements;

- Excerpts from internal guidance on SAS 99; and

- Training materials for the 2002 and 2003 SAS 99 seminars conducted for all U.S. audit partners, managers, seniors and staff.

The staff also:

- Interviewed the National Director – Professional Practice and the National Director – Audit Services to determine how the firm incorporates and communicates changes in its audit policies, procedures and methodologies;

- Evaluated the effectiveness of the design of the processes for monitoring developments that might require additions to or changes in the firm's audit policies, procedures and methodologies; and

- Evaluated the nature and content of nine recent additions to, or changes in, the firm's audit policies.

*g. Review of Policies Related to Foreign Affiliates*

The staff performed procedures in this area in order to begin forming a basis on which to evaluate the processes the firm uses to ensure that the audit work performed by its foreign affiliates on the foreign operations of U.S. clients is reliable and in accordance with the standards established by the Board. The staff did not inspect the audit work of foreign affiliates; rather, the inspection procedures with respect to such work was limited to the supervision and control, in accordance with standards established by the Board, exercised by the U.S. firm over such work.

The staff read, reviewed and analyzed the following information at the National Office:

- Policies and procedures related to the U.S. firm's supervision and control of work performed by the U.S. firm's foreign affiliates on the foreign operations of U.S. issuer clients, including those related to:

  - Procedures the U.S. firm employs to obtain reasonable assurance that the foreign affiliates and their personnel comply with the SEC's independence requirements;

  - Procedures the U.S. firm employs to obtain reasonable assurance that personnel of the affiliated firm responsible for performing the work on the foreign operations of the U.S. issuer clients are familiar with U.S. GAAP, PCAOB standards, SEC independence rules, and relevant SEC financial reporting requirements;

  - Procedures the U.S. firm employs to obtain reasonable assurance that foreign affiliates and their personnel understand and comply with relevant audit polices and procedures of the U.S. firm;

- Audit guidance related to planning and administering global or multi-location engagements;

- Guidance on audit committee or proxy reporting requirements on audit and non-audit fees;

- A summary of the results of the most recent foreign affiliated firms' internal inspection;

- Evidence related to whether professional employees in foreign affiliated firms assigned to U.S. issuer clients have sufficient familiarity with U.S. GAAP and PCAOB standards, independence rules, relevant financial reporting requirements, and the applicable policies of the U.S. firm, including:

    - The firm's training materials;

    - Policy manuals describing the involvement of the international service coordinators, and U.S. firm personnel stationed in practice offices of Deloitte Touche Tohmatsu member firms, on multinational engagement teams with respect to U.S. GAAP, PCAOB standards, related SEC accounting questions and engagement execution; and

- The firm's global international independence policy.

The staff also interviewed those responsible for oversight of the work performed by foreign affiliates on foreign operations of U.S. issuer clients. The staff interviewed the partner responsible for the foreign affiliates' internal inspection program and international training and the partner responsible for compliance with the independence rules on a global basis. Finally, the staff's procedures at the four practice offices included inspecting two audit engagement teams' supervision and control procedures over the audit work performed by the firm's foreign affiliates on the foreign operations of the U.S. issuers.

## B. Observations Concerning Audit Performance

As part of the 2003 limited inspection of Deloitte, the staff reviewed certain portions of 16 audit engagements. The selected engagements involved audits of issuers for fiscal years ended during the last half of 2002 through early 2003. In addition, the staff's review of Deloitte's internal inspection program involved or resulted in the staff reviewing aspects of four additional engagements. The staff also reviewed aspects of certain other audit engagements that came to the staff's attention in connection with a review of Deloitte's independence-related policies and procedures. Finally, the staff requested that Deloitte review the accounting by five issuers for compliance with the provisions of Emerging Issues Task Force No. 95-22 ("EITF 95-22"), *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.[4/] Based upon its review of relevant documents filed with the SEC, the staff had concluded that the financial statements of these five issuers appeared not to conform to the provisions of EITF 95-22.

This section describes, at a general level, certain deficiencies in Deloitte's audit performance as observed in this review of audit engagements. In some of the engagements reviewed, the staff identified errors in the application of GAAP that Deloitte had either not identified or not appropriately addressed during the audit. In addition to those engagements, the staff's prompting of Deloitte to review the potential misapplication of EITF 95-22 by other audit clients led to identification of three additional engagements in which that GAAP error occurred, resulting in restatements in each of those cases. In addition, some of the audit engagements reviewed were found to involve some degree of departure from PCAOB standards or Deloitte's own quality control policies.

1. Failure to Identify or Address GAAP Exceptions

*a. Staff Discoveries Resulting in Restatements by Issuers*

Eight Deloitte clients have restated their balance sheets to address GAAP exceptions as a result of the staff bringing the EITF 95-22 issue to Deloitte's attention. The provisions of EITF 95-22 require that balances under revolving lines of credit must be classified as current liabilities of the borrower if the loan agreements contain both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances whereby remittances from the borrower's customers immediately reduce the outstanding obligation. Deloitte had failed to identify that the eight issuers in question had incorrectly classified such debt as a long-term liability. The effect of this misclassification was to understate current liabilities and, thereby, to overstate working capital. In the five instances that the staff brought to Deloitte's attention, Deloitte agreed with the staff's view, and the issuers restated certain financial statements to classify the debt as a current liability. The staff asked Deloitte to review whether it had failed to detect the same error in other engagements, and Deloitte discovered three other such instances that resulted in restatements by the issuers.

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4/ The Board's staff made this same request concerning EITF 95-22 to each of the four firms inspected by the Board in 2003.

*b. Other GAAP Exceptions*

The staff identified two other GAAP exceptions. In both cases, the issuer and Deloitte concluded that the findings were immaterial, individually and in the aggregate.[5/]

(1) On one audit client's balance sheet, amounts representing additional paid-in capital were combined with amounts representing the par value of common stock outstanding, in contravention of Rule 5-02.31 of SEC Regulation S-X (17 C.F.R. § 210.5-02.31). The caption for these items was labeled only as common stock. In response to the staff's comment, Deloitte took the position that the common stock amount was *de minimus* (and also that no further work paper documentation was needed). Deloitte indicated, however, that it will request that the issuer retitle the balance sheet caption as "common stock and additional paid-in capital" in future filings.

(2) On the financial statements of one audit client, deferred income taxes were not segregated between current and non-current amounts. Deloitte has agreed to add contemporaneously dated documentation[6/] to the work papers concluding that the net current deferred income tax balance was insignificant in relation to the net deferred income tax balance as a whole.

2. Departures from PCAOB Standards and the Firm's Quality Control Policies

*a. Staff Discoveries That Led to Additional Procedures by Deloitte*

The staff's identification of departures from PCAOB standards or the firm's quality control policies did not lead to Deloitte performing significant additional procedures on any of the audit engagements reviewed.

[5/] Even if immaterial to current financial statements, some GAAP errors present the potential to be material to future financial statements if the accounting is not corrected.

[6/] As used in this report, any reference to "contemporaneous" dating of a document means that the document is dated contemporaneous with the creation of the document.

*b. Departures Other than Documentation Deficiencies*

The staff identified various departures from PCAOB standards or the firm's quality control policies that involved deficiencies other than documentation deficiencies.

(1) On one audit, the Deloitte engagement team had identified as significant accounting and auditing issues the ability of the company to continue as a going concern, impairment of long-lived tangible and intangible assets, and accrual of certain contingent liabilities. The engagement team assessed engagement risk for the audit as "normal." Based on the significant accounting and auditing issues involved, particularly the going concern risk, the staff believed the engagement risk should have been assessed, under Deloitte's internal procedures, as at least greater than normal. Deloitte has expressed its belief that the procedures performed appropriately addressed the audit risks. The staff concluded that the circumstances overall did not warrant a conclusion that the financial statements had not been audited in accordance with PCAOB standards.[7/]

Also, given the significant issues encountered during the audit, including estimates made by management, the judgmental nature of the accounting issues, and the significance of the issues in relation to the size of the company, the staff also believed that consultation beyond the local office level was warranted. In the staff's view, consultation on the accounting issues presented should have occurred with the firm's National Office professional practice group. Deloitte disagreed with this view. On this point too, the staff concluded that the circumstances overall did not warrant a conclusion that the financial statements had not been audited in accordance with PCAOB standards.

(2) The staff reviewed one engagement where there was no written communication to the audit committee regarding independence. ISB No. 1, *Independence Discussions with Audit Committees,* requires the auditor to, at least annually, "a. disclose to the audit committee, in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to

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[7/] To reach this conclusion, as described in both paragraphs of this section I.B.2.b(1) of the report, the staff considered the inherent risk of misstatement of the financial statement component at issue and of the relevant audit assertions, the materiality of these items, the impact of any relevant internal controls of the issuer, and the extent and nature of other relevant substantive procedures that the audit team carried out.

bear on independence [and] b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts." The staff determined through an interview with the audit committee chair that the required independence discussions were held, although no written communication was made. Deloitte has advised the staff that the ISB letter has subsequently been issued.

(3) In one instance, the staff identified certain actions and agreements related to a business affiliation with an audit client that raise questions about whether Deloitte complied with the SEC's and the PCAOB's independence requirements, and Deloitte's own policies. The agreements in question included "strategic alliance" agreements, "reseller arrangements," and joint marketing and sales arrangements in which Deloitte and the issuer are referred to as partners. When the staff raised concerns about the matter, Deloitte's National Office indicated that it was unaware that these business affiliations existed.

The National Office independence group then prepared memoranda analyzing the matter. The firm ultimately acknowledged that certain of the agreements included inappropriate language, which the firm contends was not actually consistent with the parties' intentions and behavior, that there were other negative factors, and that the firm's own policies were violated in some respects. The firm has expressed to the staff its view that it did not violate independence rules with respect to the issuer.[8/]

*c. Additional Departures Concerning Documentation*

The staff noted additional documentation deficiencies in the engagements reviewed. With respect to these deficiencies, the staff concluded either that other evidence allowed the staff to reach the same conclusions that the engagement team had articulated, or that, despite a lack of other evidence, those deficiencies did not render the audit as a whole deficient.[9/]

(1) With respect to the audit addressed in section I.B.2.b(1) above – where the Deloitte engagement team had identified as significant accounting and

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[8/] The Board has not, on the basis of the information reviewed in the limited inspection, reached any conclusion about whether the firm violated independence rules with respect to the issuer.

[9/] The staff reached that conclusion based on consideration of the inherent risk of misstatement and the materiality of the financial statement component at issue, combined with the extent and nature of other related internal control and substantive audit procedures carried out.

auditing issues the ability of the company to continue as a going concern, impairment of long-lived tangible and intangible assets, and accrual of certain potential contingent liabilities – the staff identified significant respects in which it could not determine from the work papers the adequacy of the audit procedures relating to these points. Discussion of the matter with the engagement partner, the senior manager, the concurring reviewer, and the National Director – U.S. Practice Review, and review of some additional documentation provided by the firm, alleviated the staff's concerns about whether many of the necessary procedures had been performed.

The additional information, however, did not alter the conclusion that the engagement team's documentation was deficient in several respects, described below. While Deloitte has indicated that it believes the documentation in the work papers is adequate, it acknowledged that additional, focused documentation to summarize the existing audit documentation into a concise, chronological depiction of the audit process with respect to the three issues discussed below would enhance a third party's review, and the firm agreed to prepare such documentation.

(i) With respect to the going concern issue, the work papers documented the engagement team's conclusion that substantial doubt about the company's ability to continue as a going concern did not exist (and that, therefore, no explanatory paragraph was needed in the audit report). The work papers failed, however, to document any testing and analysis of several significant matters related to management's cash flow projections and analysis. Nor did the work papers contain any clear indication of the degree to which the auditors placed reliance on uncommitted funds from a single source in determining the ability of the company to meet its cash flow needs. The work papers also did not document the engagement team's consideration of the potential negative cash flow impact of certain potential contingent liabilities.

(ii) With respect to impairment of long-lived assets, the work papers did not include documentation of the engagement team's consideration of the relevant minutes of the issuer's board meetings, and did not include documentation addressing how the discussions reflected in those minutes correlated to the assumptions underlying management's cash flow projections. Nor did the work papers contain documented evidence of detail testing of the cash flow projections. There also is no documentation of the engagement team's consideration of how any significant changes to certain assumptions would have affected the conclusion that the cash flows would be in excess of the carrying value of the long-lived assets (and thus that no impairment existed).

(iii) With respect to a potential contingent liability, the engagement team obtained a memo from the issuer that documented the company's conclusions regarding the loss contingency, and the engagement team documented in a memo to the work papers its conclusion that no accrual for this liability was required as of a particular date. The memo documented that the contingent liability could arise from two default provisions in an existing agreement – currently known defaults by the company or future potential defaults based on operating decisions the company was contemplating. The memo and the disclosures in the financial statements indicated that management's conclusion that an accrual was not required was based on the advice of legal counsel. The work papers maintained by the U.S. engagement team, however, did not include a copy of a letter to the issuer from its counsel containing legal advice on which the issuer had based its conclusions. Nor did the work papers make any specific reference to such a letter being maintained elsewhere. The work papers also did not provide a clear assessment as to the basis, as between the competing alternative bases, for the conclusion that accrual of the potential contingent liability was not required.

(2) Certain audit committee communications required by Statement on Auditing Standards ("SAS") No. 61, *Communications With Audit Committees,* were not documented in connection with the audits of four issuers. In each case, the staff was able to determine that the required communications had occurred based on discussions with the chair of the audit committee and with the engagement team, and Deloitte agreed to add contemporaneously dated documentation of the communications to the work papers.

(3) The staff observed various other instances of documentation deficiencies in the engagements reviewed. In each case, after the staff brought the matter to the attention of the engagement team, the engagement team prepared supplemental documentation to alleviate the deficiency.

## C. Certain General Observations

As intended, the 2003 limited inspection of Deloitte has provided an important foundation for more far-reaching inspections of the firm. Within the seven functional areas, the Board has identified issues that will warrant more probing scrutiny in a full-scale inspection, and examinations of these issues will continue in annual inspections of Deloitte. These issues, however, do not lend themselves to a thorough critique on the basis of a single, limited inspection.

As a general matter, the Board is encouraged by indications that the mere anticipation of a review of the firm's practices may already have had a positive effect on the firm, as the staff found a number of recent changes to firm policies and procedures relating to some of the seven functional areas. The Board is also encouraged by indications that the firm understands that the Act calls for a renewed and heightened focus on audit quality. In addition, the firm was cooperative and responsive with respect to questions raised by the staff about compliance with auditing standards and accounting principles.

Even so, the Board intends to maintain a critical eye, through the inspection process, on the development of the firm's initiatives, and their impact on audit quality, over time. The limited inspection has revealed issues that Board inspectors will probe more deeply in future inspections and that the Board will expect the firm to address as the Board refines its understanding of the firm's practices.

**END OF PART I**

**PART II OF THIS REPORT IS NONPUBLIC AND IS OMITTED FROM THIS PUBLIC DOCUMENT**

## PART III

## RESPONSE OF DELOITTE TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided Deloitte an opportunity to review and comment on a draft of this report. Deloitte provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change made to the report before the Board finalizes the 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. In any version of this report that the Board makes publicly available, any portions of the firm's response that address nonpublic portions of the report are omitted.

Deloitte.

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July 22, 2004

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

Dear Mr. Diacont:

Deloitte & Touche LLP ("D&T") is pleased to respond to the Board's June 22, 2004 draft report on its 2003 limited inspection, in accordance with Section 104(f) of the Sarbanes-Oxley Act of 2002 (the "Act"). Given the nature of conducting audits, we believe that inspection can be an effective means of monitoring audit quality, and welcome the Board's process in addition to our experience with our internal inspections and with peer reviews over the years. We believe inspections by the Board are of considerable value to the public and its confidence in the integrity of the independent audit process, and we are supportive of the Board's new responsibilities.

D&T is committed to conducting the highest quality audits and to prompt and effective response to constructive criticism. We voluntarily agreed to submit to this initial limited inspection in the interest of restoring the public confidence through cooperating with the Board's desire to take immediate steps to assess the public company audit environment. We believe that improvement of audit quality should be the primary objective of an inspection process and that conclusions reached from such a process should be assimilated into the audit process through remedial action such as changes to audit methodologies, policies and procedures, or through additional training of our partners and our staff.

Our response to certain specific observations in the draft report is set forth below, followed by some brief additional comments on the report in general.

EITF 95-22 Issues
During the course of the inspection, the staff discovered that application of EITF 95-22, which deals with a somewhat unusual provision of certain forms of credit agreements, was not applied properly in certain circumstances. The staff initially identified several situations in which revolving credit debt had been misclassified. Further investigation identified additional similar situations. In all cases, our clients restated their balance sheets to reflect the appropriate classification.

We take these misclassifications very seriously, and we have undertaken a process to evaluate precisely what was omitted and how new processes and procedures can preclude a recurrence. We will be modifying our audit procedures and conduct appropriate training once our evaluation is complete.

Other GAAP Exceptions
The inspectors noted two "other GAAP exceptions," neither of which were deemed material. We have addressed both of these matters as noted in the report, and we agree that no further action is necessary.

Departures Other Than Documentation
The draft inspection report noted three non-documentation matters. The inspectors indicated that they were satisfied with the responses of our engagement teams to these matters and expressed no adverse conclusions regarding the overall audits in question. We agree that no further action is necessary.

Documentation Concerns
The staff noted documentation deficiencies in a number of engagements. In each case, the inspectors viewed other evidence that allowed them to reach the same conclusions reached by the audit team or otherwise concluded that the documentation deficiencies did not rise to a level that would render the audits deficient. In each case, we addressed the inspectors' concerns by preparing additional documentation or taking other appropriate steps.

Documentation is one of the most difficult challenges of the audit process, and we recognize that audit documentation must be improved throughout the profession. We are actively reviewing and revising our documentation policies and procedures to address the new standards proposed by the PCAOB. We have made and we will continue to make significant improvements in documentation, but we also need to be mindful that expectations regarding documentation are increasing at the same time that new standards and expectations are being imposed on the substantive audit process. The timing and interaction of the client's finalization of its financial statements and disclosures, the auditor's completion of its work, increasing communication with audit committees, and shortened reporting periods for public companies place real pressure on the preparation of comprehensive documentation. While improvements in audit documentation can and will be made, it is important that the emphasis on documentation does not come at the expense of improvement in the substance of the audit process.

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General Comments

The observations made in Part I of the report were gathered from review of audit workpapers relating to specific audits covered in the limited inspection. We observe that the Board has chosen to limit its report to the observations made in the Inspection Program Comment Forms provided to us at the time of its review. We believe that it will be difficult for investors, issuers, audit committees, and other regulators to understand the meaning of these isolated observations and their impact on audit quality. We believe the public would benefit and better understand the report if the Board provided a more concise and evaluative form of report.

During the course of the limited inspection, the reviewers identified several instances in which D&T had used "best practices." These practices were deemed sufficiently beneficial to audit quality to be mentioned in the staff's written comments. We recommend that they be included in the final report along with the other observations. Inclusion of the "best practices" would bring some sense of balance to the report, which otherwise focuses almost exclusively on review criticisms which were made and promptly addressed at the time of the inspection. We believe that a more balanced report would give the public a more accurate picture of the results of the inspection.

D&T notes that both Congress and the PCAOB have emphasized the importance of confidentiality in the conduct of inspections, including with respect to materials received by, or prepared for, the Board and its staff. Nothing in this response should be deemed to waive or limit in any way D&T's ability, consistent with the regulatory regime, to assert its confidentiality rights and interests hereafter.

We are hopeful that our comments will be viewed in the constructive context in which they were made. We are available to the Board and its staff to further discuss our response. Please contact Robert J. Kueppers, 203-761-3579, with any questions.

Sincerely,

Deloitte & Touche LLP