



1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

Report on
2005 Inspection of Ernst & Young LLP

Issued by the
Public Company Accounting Oversight Board
January 11, 2007

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. 104-2007-001

Preface to Reports Concerning Annually Inspected Firms

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("PCAOB" or "the Board") to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers. The Board's report on any such inspection includes this preface to provide context for information in the public portion of the report.

A Board inspection includes, among other things, a review of selected audits of financial statements and of internal control over financial reporting. If the Board inspection team identifies deficiencies in those audits, it alerts the firm to the deficiencies during the inspection process. Deficiencies that exceed a certain significance threshold are also summarized in the public portion of the Board's inspection report. The Board encourages readers to bear in mind two points concerning those reported deficiencies.

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these 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 previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take, action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Second, the Board cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

During 2005, the Board monitored the implementation of the provisions of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2") by annually inspected U.S. firms. Among other things, that monitoring included Board staff meetings with these firms to discuss their methodology and to discuss opportunities to enhance the effectiveness and efficiency of audits of internal control. As the Board has previously stated, the Board believes that audits performed under the difficult circumstances of the first year of implementation of AS No. 2 were often not as efficient as the standard intends, and as the Board expects them to be in future years. The primary reasons for this failure to achieve expected efficiencies are described in the Board's Report on the Initial Implementation of Auditing Standard No. 2 ("the Report").^{1/} In general, as described in the Report, in the 2005 inspections of certain firms, the Board's inspectors observed that, in a significant number of the engagements they selected for inspection of the application of AS No. 2, the auditors did not integrate their audits of internal control with their audits of the financial statements; did not use a top-down approach; and did not alter the nature, timing, and extent of their procedures to reflect the level of risk within a given area.

^{1/} See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (November 30, 2005).

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 supervisory context in which this report was prepared. Any such references 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. Board inspections encompass, among other things, whether the firm has failed to identify departures from U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure 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 or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



2005 INSPECTION OF ERNST & YOUNG LLP

In 2005, the Board conducted an inspection of Ernst & Young LLP ("E&Y" or "the Firm"). 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, Appendix B, and portions of Appendix C. Appendix B provides an overview of the inspection process. Appendix C includes the Firm's comments, if any, on a draft of the report.^{2/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{3/} 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.

^{2/} 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 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.

^{3/} 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 inspection team") performed an inspection of the Firm from August 2005 to December 2005. The inspection team performed field work at the Firm's National Office and at 18 of its approximately 80 U.S. practice offices.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system. Appendix B to this report provides a description of the steps the inspection team took with respect to the review of audits of financial statements and of internal control over financial reporting and the review of eight functional areas related to quality control.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.^{4/} It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of selected audits of financial statements and of internal control over financial reporting performed by the Firm. Those audits and aspects were selected according to the

^{4/} When the Board becomes aware that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies. Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the Firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claims to have performed the procedure. PCAOB Auditing Standard No. 3 ("AS No. 3"), in effect for most of the audits reviewed in the inspection,^{5/} 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.^{6/} For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions,^{7/} and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers. In some instances

^{5/} Auditing Standard No. 3, *Audit Documentation*, applies to audits with respect to fiscal years ending on or after November 15, 2004.

^{6/} See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

^{7/} See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

in which the inspection team identified GAAP departures, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.^{8/}

In some cases, 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 competent evidential matter to support its opinion on the issuer's financial statements. In some of those audits, that conclusion followed from the omission, or insufficient performance, of a single procedure, while other audits included more than one such failure. The deficiencies that reached this degree of significance are described below (without identifying the issuers).^{9/} The deficiencies are discussed here on an audit-by-audit basis.

Issuer A

In this audit, the Firm failed to address appropriately a departure from GAAP before issuing its audit report. In 2003, the issuer revised its inventory standard costs to include certain indirect costs that the issuer had previously expensed when incurred. Instead of recognizing the effect of the accounting change in net income immediately, or over a period commensurate with its inventory turnover periods, which ranged from three to nine months, the issuer chose to amortize the effect of the accounting change into net income on a straight-line basis over a six-year period.

Issuer B

In this audit, the Firm failed to address appropriately a departure from GAAP before issuing its audit report. The issuer incorrectly classified as part of operating

^{8/} The Board inspection process generally did not include review of such additional procedures or documentation, or of such revised accounting, although future Board inspections of the Firm may, as appropriate, include further review of any of these matters.

^{9/} The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

income a gain on the sale of an interest in a joint venture. The gain should have been reported as part of other income.^{10/}

Issuer C

The issuer's business is technology-intensive and includes processing large volumes of customer data. The Firm chose not to test the operating effectiveness of information technology controls. It failed to test the completeness and accuracy of computer-generated information that the Firm used to perform audit procedures on revenue and accounts receivable. The Firm also failed to perform sufficient substantive audit procedures with respect to revenue, including unbilled revenue. The Firm failed to test, other than through analytical review of issuer-prepared reports, unbilled revenue.

Issuer D

In this audit, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient audit procedures with respect to three matters related to income tax contingencies. First, regarding the issuer's basis for accruing certain significant income tax contingencies, the Firm failed to assess certain factors that potentially impact the likelihood of occurrence and failed to test the estimate of the amount accrued by the issuer. Second, the Firm failed to evaluate whether the issuer's policy on releasing reserves for income tax contingencies was consistent with GAAP and failed to determine whether the application of such policy resulted in inappropriate liabilities for income tax contingencies. Third, the Firm failed to evaluate the issuer's conclusion that no income tax reserve was required for certain significant items identified as disallowed in a report received in connection with an Internal Revenue Service audit.

Issuer E

In this audit, the Firm failed in two respects to obtain sufficient competent evidential matter to support its audit opinion –

- The issuer exchanged certain of its debt for debt at a lower interest rate and extended maturity and for cash. There was no evidence in the audit

^{10/} Another issuer later acquired this issuer. This issuer's 2004 financial statements, included in an 8-K filing of the acquiring company, were restated to reflect the gain on the sale as other income.

documentation, and no persuasive other evidence, that the Firm had performed procedures to test the issuer's accounting for the debt exchange, including testing the issuer's assumptions and calculations and analyzing the terms of the new debt.

- In connection with a merger, the issuer assumed convertible debt securities and, as a result of the merger, certain terms and features of the convertible debt securities were changed. The Firm failed to evaluate the effect of the changes on the accounting for the securities. These changes included changes to the conversion and settlement options and certain contingent features.

Issuer F

In this audit, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient procedures to evaluate the valuation models that the issuer had used to assess whether goodwill for a certain reporting unit was impaired. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the overall appropriateness of the model that the issuer used or that it had tested certain of the significant assumptions that contributed to the model, such as the assumption that revenues would increase despite their decline during the past two years.

Issuer G

In this audit, the Firm failed to perform sufficient procedures with respect to using the findings of a specialist hired by the issuer to determine the fair value assigned to acquired in-process research and development. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained an understanding of certain critical methods and assumptions that the specialist used, or that it had performed tests of certain critical data provided to the specialist.

Issuer H

In this audit, the Firm failed to perform sufficient procedures to evaluate the financial statement classification of an issuer's reversal of a contingent tax accrual. Three years earlier, the issuer had disposed of a business and included the net gain on disposition in discontinued operations. The issuer classified this business as discontinued operations for the next three years. During the year under audit, the

issuer settled outstanding matters with the IRS and also resolved disputes related to tax indemnification provisions with the purchaser of the business. Following these events, the issuer reversed a contingent tax accrual that appeared to relate to the sold business and included the reversal in continuing operations. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed sufficient procedures, such as analyzing whether the components of the reserve related either to the sold business or to other matters, to conclude whether the reversal of the contingent tax accrual should have been reported as continuing operations or discontinued operations.

Issuer I

The issuer maintained a liability for post-retirement benefits of certain former employees of businesses it had sold in prior years. A memorandum in the Firm's work papers indicated that the liability represented the undiscounted portion of the issuer's post-retirement obligation, and that it had been established to be conservative and that such costs were difficult to estimate. The issuer reduces the recorded liability each year, and the reduction consists of an interest component and an actuarially determined amount derived from the remaining lives of the former employees. Although the Firm tested the amount recognized for the year, it did not perform procedures to evaluate whether the amount of the recorded liability was appropriate.

Issuer J

In this audit, the Firm failed to appropriately evaluate the issuer's accounting related to a settlement agreement entered into with another company during the year under audit. The settlement agreement was executed to resolve two disputes that had arisen between the parties in prior years. One dispute concerned a lawsuit filed by the other company against the issuer, asserting that certain services infringed patents owned by the other company. The second dispute concerned fair value estimates underlying a warrant, which had been issued in a prior year in connection with an agreement, that the other company had exercised to purchase shares of the issuer's stock. In connection with the settlement of these two disputes, the issuer issued to the other company shares of its common stock. The issuer recognized a majority of the settlement consideration as a non-recurring charge at the time of settlement and presented the charge as a separate line item in its consolidated statement of income. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether a portion of the settlement consideration related to

a prior period or had addressed the income statement classification of the settlement charge.

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies, and procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following eight functional areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) the supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. issuer audit clients. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

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

APPENDIX B

THE INSPECTION PROCESS

The inspection process was designed and performed to provide a basis for assessing the degree of compliance of the Firm with applicable requirements and standards related to auditing issuers. This process included reviews of components of selected issuer audit engagements completed by the Firm. These reviews were intended both to identify deficiencies, if any, in the conduct of those audits and to determine whether the results of those audits indicated deficiencies in the design or operation of the Firm's system of quality control over audits. In addition, the inspection included reviews of the design of, and in some cases the application of, policies and procedures related to certain functional areas of the Firm that could be expected to influence audit quality.

1. Review of Selected Audit Engagements

The inspection team reviewed aspects of selected audits performed by the Firm. The inspection team chose the engagements according to the Board's criteria. The Firm was not allowed an opportunity to limit or influence the engagement selection process or any other aspect of the review.

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenues, reserves or estimated liabilities, derivatives, income taxes, related party transactions, supervision of work performed by foreign affiliates, assessment of risk by the audit team, and testing and documentation of internal controls by the audit team. The inspection team also analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. For certain selected engagements, the inspection team reviewed written communications between the Firm and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

The inspection team also reviewed aspects of certain of the Firm's audits of internal control over financial reporting. For each audit engagement selected for this purpose, the inspection team reviewed the Firm's work papers and interviewed

engagement personnel regarding the audit approach, including the use of a top-down approach, the assessment of risk, the evaluation of management's assessment of internal control, and the integration of the audit of internal control over financial reporting with the audit of the financial statements. The inspection team also selected certain significant processes and, for those processes, reviewed the Firm's evaluation of the design effectiveness of controls, including the performance of walkthroughs, and the performance of tests of operating effectiveness of controls. For the selected engagements, the inspection team also reviewed the Firm's evaluation of any control deficiencies that the Firm identified during the Firm's audit of the issuer's financial statements.

When the inspection team identified a potential issue, it discussed the issue with members of the engagement team. If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other documentation, the inspection team issued a comment form on the matter and the Firm provided a written response to the comment form. In certain instances, if the inspection team was unable to resolve the issue through these processes, the inspection team requested that the engagement team consult with the Firm's professional practice personnel. In many cases, this process resulted in resolution of the matter, either because the Firm agreed with the position the inspection team had taken and the Firm or the issuer took steps in light of the significance of the error to remedy the exception, or because the Firm was able to provide additional information that effectively addressed the inspection team's concerns.

2. Review of Eight Functional Areas

The inspection team conducted the procedures related to the review of the eight functional areas primarily at the Firm's National Office. With respect to six of the eight functional areas, the inspection team also conducted procedures at certain of the Firm's practice offices. The inspection team performed these procedures both to identify possible defects in the Firm's system of quality control and, where applicable, to update the Board's knowledge of the Firm's policies and procedures in the functional areas. A more detailed description of the scope with respect to each of the eight functional areas follows.

a. Review of Partner Evaluation, Compensation, Admission, Assignment of Responsibilities, and Disciplinary Actions

The inspection team reviewed the Firm's policies and procedures related to partner evaluation, partner compensation, nomination and admission of new partners, assignment of responsibilities, disciplinary actions, and termination of partners. The objective of the inspection procedures was to assess whether the design of these processes, as documented and communicated, could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm.

The inspection team interviewed four members of the Firm's leadership at its National Office. In addition, the inspection team analyzed schedules provided by the Firm that detailed information on each partner, including the partner's office location, recent evaluation history, and compensation history. The inspection team also reviewed a sample of partners' personnel files, including files of newly admitted partners, partners who resigned or took early retirement, and partners who received bonus compensation.

b. Review of Independence Policies

The objectives of the inspection procedures in this area included evaluating the Firm's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer audit clients; Firm participation in business ventures, alliances, and arrangements; commissions and contingent fee arrangements; the relationships of Firm professionals with issuer audit clients; and the provision of non-audit services related to issuer audit clients' compliance with Section 404 of the Act. To accomplish these objectives, the inspection team reviewed the Firm's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team also reviewed the Firm's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures; tested the Firm's independence consultation process; and reviewed information concerning the Firm's existing business ventures, alliances, and arrangements, as well as the Firm's process for establishing such enterprises. The inspection team also interviewed numerous National Office and practice office personnel regarding the Firm's independence policies, practices, and procedures.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, reviewed relevant information to identify

any non-audit services performed for the issuer, including whether any of the services involved commissions or contingent fee arrangements; to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement; and to determine whether the Firm was involved in any business ventures, alliances, or arrangements with the issuer. In addition, for the sample, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

c. Review of Client Acceptance and Retention Policies

The objectives of the inspection procedures in this area were 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, that it undertakes only engagements within its professional competence, and that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed the Firm's policies, procedures, and forms related to client acceptance and continuance; evaluated documentation related to new clients and to clients that had recently changed auditors from the Firm; and interviewed members of the Firm's leadership.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, evaluated whether the client acceptance or continuance documentation was completed and approved in accordance with Firm policies; interviewed the audit partners and managers on these engagements concerning the reasons for accepting the issuer as a client or continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks; and assessed whether the audit planning documentation incorporated the specific actions, if any, contemplated in response to any identified risks.

d. Review of Practices for Consultations

The objective of the inspection procedures in this area was to assess the Firm's compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters. Toward this objective, the inspection team gained an understanding of and evaluated the Firm's policies and procedures relating to its consultation process. The inspection team also reviewed a sample of consultations that occurred during the inspection period to evaluate the effectiveness of the Firm's consultation process, its compliance with the Firm's policies and procedures, whether

the conclusions were in accordance with professional standards, and whether the engagement teams acted in accordance with the conclusions.

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, as well as to assess the Firm's compliance with the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance, and forms related to the Firm's internal inspection program, documentation of the results of the current year's inspection program, and steps the Firm took in response to those results. The inspection team also interviewed the Firm's leadership concerning the process and effectiveness of its internal inspection program.

The inspection team reviewed and tested the conduct of the internal inspection program by performing field work in three practice offices where the Firm had conducted internal inspections. These procedures included evaluating the qualifications of the Firm's inspectors, reading the inspectors' comments, reviewing the results of the inspectors' review of certain Firm-wide functional areas, and interviewing both area leadership and selected audit personnel concerning the internal inspection program. In addition, for a sample of the engagements that the internal inspectors had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with the Firm any significant differences in the results of the inspection team's review and that of the Firm's internal inspectors.

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

The objectives of the inspection procedures in this area were to update the inspection team's 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; and to evaluate changes in audit policies that the Firm had made since the Board's most recent inspection of the Firm.

Toward those objectives, the inspection team reviewed documentation relating to the Firm's method for developing policies and procedures, as well as internal guidance and/or training materials distributed to audit personnel with respect to recent changes in

requirements and with respect to selected specific areas. The inspection team also evaluated the effectiveness of the design of the Firm's processes for monitoring developments that could affect the Firm's audit policies, procedures, and methodologies.

g. Review of Policies Related to Foreign Affiliates

The objective of the inspection procedures in this area was to evaluate the processes the Firm uses to ensure that the audit work that its foreign affiliates perform on the foreign operations of U.S. issuers is effective and in accordance with standards established by the Board. The inspection team did not inspect the audit work of foreign affiliates; rather, the inspection procedures in this area were limited to the supervision and control exercised by the U.S. engagement team over such work.

To accomplish this objective, the inspection team reviewed the Firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the foreign operations of U.S. issuer clients; analyzed audit guidance related to planning and administering multi-location engagements; and reviewed available information relating to the most recent foreign affiliated firms' internal inspections. In addition, the inspection team interviewed members of the Firm's leadership with responsibility for oversight of the work performed by foreign affiliates on foreign operations of U.S. issuer clients. Finally, with respect to a sample of the engagements reviewed, the inspection team reviewed the U.S. engagement team's supervision and control procedures concerning the audit work that the Firm's foreign affiliates performed.

h. Review of Tone at the Top

The 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 Act, the rules of the Board, the rules of the SEC, and PCAOB standards in connection with the Firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at the Firm's National Office. Such information included the Firm's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships between and among, the Firm's staff and leadership; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; and agendas and



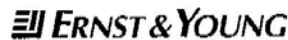
minutes of the Firm's board of directors. In addition, the inspection team interviewed numerous members of the Firm's leadership team.

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.^{11/}

^{11/} 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. In some cases, the result may be that none of the Firm's response is made publicly available.



Ernst & Young LLP
5 Times Square
New York, New York 10036

Phone: (212) 773-3000
www.ey.com

December 12, 2006

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

Response to Report on 2005
Inspection of Ernst & Young LLP

Dear Mr. Diacont:

We are pleased to provide our response to the Public Company Accounting Oversight Board regarding the Report on 2005 Inspection of Ernst & Young LLP (the "Report"). The inspection process is a fundamental component of the PCAOB's mission.

As the independent auditor of more than 2,300 public companies in the United States, our overriding objective is to make certain that all aspects of our auditing and quality control processes are of high quality for the continued benefit of the capital markets in which the public participates and on which they rely. The PCAOB's inspections assist us in identifying areas where we can continue to improve our performance.

We respect the PCAOB's inspection process and understand that judgments are involved both in performing an audit and in subsequently inspecting it. Recognizing the constructive intent of the inspection process, we made every effort to cooperate with the inspection staff. Therefore, we thoroughly evaluated the matters described in *Part I – Inspection Procedures and Certain Observations* of the Report and have taken actions where appropriate in accordance with E&Y's policies and PCAOB standards.

All of the matters described in the Report were important and as such were addressed during our audits. Although we do not always agree with the general characterization of the work we performed or the related existing audit documentation, in some instances we did agree to perform certain additional procedures or improve aspects of our audit documentation in response to the inspection. In all instances, no new facts came to our attention that caused us to believe that our previously issued auditor's reports should be withdrawn as a result of these actions.

We have the following additional comments regarding the matters described in the Report.

Issuer A – The engagement team recognized the GAAP departure described in the Report during the 2003 audit before issuing the audit report and discussed the matter with management and the audit committee. However, our audit documentation did not include the matter on our Summary of Audit Differences for the 2003 or 2004 audits. In response to the inspection, we supplemented our audit documentation accordingly.

Mr. George Diacont

Page 2
December 12, 2006

Issuer B – The engagement team evaluated and made a judgment on the income classification issue described in the Report during the 2004 audit before issuing the audit report. Upon further consideration, the gain on the sale of the joint venture interest should have been classified as part of other income rather than operating income. The misclassification did not affect reported net income or earnings per share.

Issuer C – The engagement team performed audits of the issuer's financial statements for a nine-month stub period ended September 30 and for the year ended December 31, 2004. The issuer was not yet required to implement the requirements of Section 404 and the engagement team intentionally took a substantive approach to the financial statement audit, i.e., not a controls-reliant approach. As a result of the inspection, we performed additional procedures pertaining to certain computer-generated information used during the audit, performed certain other procedures pertaining to revenue and accounts receivable, and supplemented our audit documentation accordingly. Our original audit conclusions remained unchanged.

Issuer D – The matters described in the Report were important matters addressed by the engagement team, which included tax specialists, during the 2004 and prior audits. Each of the matters was thoroughly considered and evaluated by the engagement team, discussed with management, and the significant matters discussed with the audit committee. As a result of the inspection, we supplemented our audit documentation to more precisely describe the work performed at the time of the audit. Certain audit documentation related to these matters was carried forward from our audit documentation for the prior year.

Issuer E – The matters described in the Report were important matters addressed by the engagement team during the 2004 audit and as such were included in our audit documentation. Upon further consideration, the engagement team did not document its evaluation of the effects of the changes to the convertible note terms using all of the applicable accounting literature. However, after applying all of the applicable accounting literature to the evaluation of the recording of the transaction, our original audit conclusions remained unchanged. We supplemented our audit documentation accordingly.

Issuer F – The matters described in the Report were important matters addressed by the engagement team during the 2004 audit and as such were included in our audit documentation. As a result of the inspection, we reconsidered aspects of the issuer's impairment computation, had the computation reviewed by one of our valuation specialists, and supplemented our audit documentation accordingly. Our original audit conclusions remained unchanged.

Issuer G – The matters described in the Report were important matters addressed by the engagement team during the 2004 audit and as such were included in our audit documentation. As a result of the inspection, we supplemented our audit documentation to more precisely describe the work performed at the time of the audit.

Mr. George Diacont

Page 3
December 12, 2006

Issuer H – The matters described in the Report were important matters addressed by the engagement team during the fiscal 2005 audit and as such were included in our audit documentation. The issue raised in the Report is one of classification. The tax contingency accrual was established in prior years for items not related to the disposed business, and therefore appropriately reversed through continuing operations upon the settlement of the outstanding matters with the IRS (and not due to the resolution of the tax indemnification dispute with the purchaser of the business). We believe the issuer's accounting for the tax matters, including the classification of the reversal, was appropriate. As a result of the inspection, we supplemented our audit documentation to more precisely describe the work performed at the time of the audit.

Issuer I – The 2004 audit of the issuer was inspected by the firm's internal inspection program prior to the PCAOB's re-inspection. The matter described in the Report was identified by the firm's internal inspection and brought to the PCAOB's attention prior to its re-inspection. Appropriate follow-up actions were taken in response to the firm's internal inspection.

Issuer J - The matter described in the Report was an important matter addressed by the engagement team during the 2004 audit and as such was included in our audit documentation. The matter was thoroughly considered and evaluated by the engagement team and discussed with management before issuing the audit report. We continue to believe that the issuer's accounting, including the classification of the charge, was appropriate, and therefore have taken no further action.

* * * * *

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

Respectfully submitted,

Ernst & Young LLP

Copy to: Mr. Mark W. Olson
Ms. Kayla J. Gillan
Mr. Daniel L. Goelzer
Mr. Bill Gradison
Mr. Charles D. Niemeier