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

Report on

2011 Inspection of Ernst & Young LLP
(Headquartered in New York, New York)

Issued by the

Public Company Accounting Oversight Board

December 6, 2012

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. 104-2012-272

PCAOB

Public Company Accounting Oversight Board

PCAOB Release No. 104-2012-272

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 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 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 financial statement misstatements, including failures to comply with 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 apparent misstatements 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 whether an issuer's financial statements are misstated or fail to comply with Commission disclosure requirements, rests with the Commission. Any description, in this report, of financial statement misstatements or failures to comply with 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.

PCAOB
Public Company Accounting Oversight Board

2011 INSPECTION OF ERNST & YOUNG LLP

Preface

In 2011, the Public Company Accounting Oversight Board ("PCAOB" or "the Board) conducted an inspection of the registered public accounting firm Ernst & Young LLP ("E&Y" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is issuing this report in accordance with the requirements of the Act.[1/] The Board is releasing to the public Part I of the report, Appendix C, and portions of Appendix D. Appendix C provides an overview of the inspection process for annually inspected firms.[2/] Appendix D includes the Firm's comments, if any, on a draft of the report.[3/] A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), is nonpublic, unless the firm fails to make sufficient progress in addressing those criticisms.

[1/] In its Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004), the Board described its approach to making inspection-related information publicly available consistent with legal restrictions.

[2/] The Act requires the Board to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers.

[3/] 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.

PCAOB
Public Company Accounting Oversight Board

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm performs audit work.[4/] To achieve that goal, Board inspections include reviews of certain aspects of selected audit work performed by the firm and reviews of certain aspects of the firm's quality control system. It is not the purpose of an inspection, however, to review all of a firm's audit work or to identify every respect in which reviewed work is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audit work, or the relevant issuers' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

If the Board inspection team identifies deficiencies that exceed a certain significance threshold in the audit work it reviews, those deficiencies are summarized in the public portion of the Board's inspection report.[5/] The Board cautions, however, against extrapolating from the results presented in the public portion of the report to broader conclusions about the frequency of deficiencies throughout the Firm's practice. Audit work is selected for inspection largely on the basis of an analysis of factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

4/ This focus on weaknesses and deficiencies necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

5/ Inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. 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 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. The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements. Failure by a firm to take appropriate actions, or a firm's misrepresentations, in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from April 2011 to December 2011. The inspection team performed field work at the Firm's National Office and at 31 of its approximately 66 U.S. practice offices.

A. Review of Audit Engagements

The 2011 inspection of the Firm included reviews of aspects of 55 audits performed by the Firm and a review of the Firm's audit work on another issuer audit engagement in which the Firm played a role but was not the principal auditor. The inspection team selected the audits and aspects to review, and the Firm was not allowed an opportunity to limit or influence the selections.

The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. Those deficiencies included failures by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[6/] as well as failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures. In some instances, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices.

In some cases, the conclusion that the Firm failed to perform a procedure was based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claimed to have performed the procedure.[7/]

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

7/ PCAOB Auditing Standard ("AS") No. 3, *Audit Documentation* provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did

One of the deficiencies described below relates to auditing aspects of an issuer's financial statements that the issuer restated after the primary inspection procedures.[8/]

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR"). The audit deficiencies that reached these levels of significance are described below.[9/]

A.1. Issuer A

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

- The issuer's revenue was produced from numerous locations, each with its own accounting personnel and general ledger systems. Each location processed similar classes of routine transactions. The engagement team identified risk factors associated with individual locations, including ineffective controls over access to the general ledger system used at the locations and instances of fraud at certain of the locations. The Firm and the issuer's internal audit ("IA") identified multiple control deficiencies, including deficiencies at several locations tested, but these control deficiencies were not the same at all locations. In planning and performing tests of controls, the Firm assumed that risks and controls were the same across all locations and, therefore, reduced the number of

---

so, and that oral assertions and explanations alone do not constitute persuasive other evidence.

8/ The Board inspection process did not include review of any additional audit work related to the restatement and adjustment.

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.

locations selected for testing. As these assumptions were incorrect, the Firm's testing was insufficient.

- The Firm relied on the effective operation of certain of the issuer's review controls to reduce the scope of its testing, and it identified these review controls as compensating controls for certain of the identified control deficiencies. The Firm's testing of the review controls was deficient, as follows –

  - The Firm failed to perform sufficient procedures to test the effectiveness of the review controls, including whether they operated at a level of precision to prevent or detect errors that could result in a material misstatement to the financial statements. Specifically, the Firm's procedures were limited to inquiring of management, verifying that certain actions performed as part of the controls had occurred, and, for each control, attending one meeting at which reviews occurred. The Firm understood that the nature and extent of the reviews varied, as several individuals performed the reviews, and the issuer had not prescribed the performance indicators to be reviewed or the thresholds to be used. The Firm failed to evaluate the specific performance indicators reviewed, the criteria for follow-up of variances, and the appropriateness of the actions taken as a result of the reviews.

  - The Firm failed to identify and test any controls over the manually generated reports that the issuer used in the operation of the review controls.

- The Firm failed to sufficiently evaluate whether the control deficiencies that it and the issuer's IA had identified at the issuer's locations were, in combination, material weaknesses. Specifically, the Firm failed to evaluate the extent to which the identified control deficiencies would be applicable to the issuer's locations that were not tested. In addition, the Firm identified, as compensating controls for certain of the deficiencies, the review controls discussed above, of which the Firm's testing was deficient.

- Despite the varying degrees of risks associated with the controls, the Firm's procedures to update its testing of controls for the five-month period between its interim testing and year end were limited to obtaining a memorandum from IA summarizing the results of IA's inquiries of the control owners.

- The Firm failed to test journal entries recorded at the issuer's individual locations, despite ineffective controls over access to the locations' general ledger systems, instances of fraud at the locations, and a significant volume of journal entries processed at the locations.

- The Firm failed to identify and test any controls over a significant component of revenue at any of the issuer's locations. Instead, the Firm relied on the review controls discussed above that were insufficiently tested. In addition, the Firm failed to perform sufficient substantive procedures to test this component of revenue. Specifically, in performing analytical procedures that the Firm intended as its primary substantive tests, the Firm failed to (1) appropriately develop its expectations, as it failed to obtain support for its expectation that revenue would be consistent with revenue in prior periods; (2) for some analytical procedures, set a threshold for investigation of unexpected differences at a level that would detect a material misstatement; (3) test the completeness and accuracy of certain data used in certain of the analytical procedures; and (4) obtain corroboration of management's explanations for significant differences.

- The Firm failed to perform sufficient substantive procedures to test the completeness, existence, and valuation of certain inventory. Specifically, the Firm failed to –

    - Test whether the adjustments resulting from the issuer's physical inventory counts were recorded to the general ledger in the proper period;

    - Perform procedures for the four- to six-month period between its interim testing and year end related to the existence of inventory at the issuer's individual locations; and

    - Perform substantive procedures to test the cost of certain inventory.

A.2. Issuer B

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

- The issuer had multiple production locations within two of its divisions, and many accounting functions were distributed among the corporate office, divisions, and certain production locations. The Firm and the issuer's IA identified multiple control deficiencies at the locations, including deficiencies at most locations, but the nature and causes of the control deficiencies were not consistent across all locations. Further, the issuer had recently implemented workforce changes and reductions, which increased the risk of inconsistent application of controls. Despite these factors, in planning and performing tests of controls, the Firm assumed that risks and controls were the same across all locations within these divisions and, as a result, reduced the number of locations selected for testing. As these assumptions were incorrect, the extent of the Firm's testing for these two divisions was insufficient.

- The issuer's period-end financial reporting process was decentralized and included manual activities at the various locations. The Firm identified deficiencies related to controls over journal entries at the locations involved in the period-end financial reporting process. The Firm also determined that large numbers of personnel had the ability to modify general ledger records related to the period-end financial reporting process. The Firm failed to perform sufficient testing of certain controls related to the period-end financial reporting process. Specifically –

  - The Firm failed to identify and evaluate a control deficiency related to the approval of journal entries.

  - The Firm failed to select and test controls over the specific user-definable settings that the issuer's general ledger system applied in the automated consolidation process.

- The Firm tested certain of the entity-level controls ("ELCs") that the issuer used to monitor its financial results, but this testing was insufficient. Specifically, for some of these controls, the Firm failed to test whether the controls operated at a level of precision to prevent or detect errors or fraud that could result in a material misstatement. For another control, the Firm's testing of the operating effectiveness was limited to verifying that relevant documentation was prepared by an appropriate level of management or inspecting evidence of sign-off without evaluating the underlying review process.

- The Firm failed to sufficiently evaluate whether the numerous and pervasive control deficiencies that it and the issuer's IA had identified were, individually or in combination, material weaknesses. Specifically –

  - There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether there were multiple control deficiencies affecting the same account or disclosure that, in combination, resulted in a material weakness.

  - In evaluating the control deficiencies, the Firm identified certain mitigating controls. The Firm, however, failed to evaluate whether identified deficiencies in those mitigating controls affected their ability to compensate for the identified deficiencies in the other controls.

  - The Firm determined that certain control deficiencies were remediated before year end, but the remedial actions the Firm cited consisted of future actions, and the Firm did not perform procedures to determine whether these actions had occurred.

- The Firm used the work of IA as evidence regarding the effectiveness of certain important controls related to multiple processes, including in areas that the Firm assessed as higher risk, such as inventory, revenue, and accounts receivable. IA made selections from both the year under audit and the prior year to test the operating effectiveness of controls for which the Firm used IA's work as evidence. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether IA's testing of controls for the year under audit was sufficient to support a conclusion on the operating effectiveness of those controls as of the end of the year under audit.

A.3. Issuer C

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

- The Firm failed to sufficiently test controls over the period-end financial reporting process for one of the issuer's significant divisions involved in that process. The controls the Firm selected for testing in this area generally were manual controls that included reconciliations, reviews of financial results, and reviews and approvals of journal entries at certain locations within the division. The deficiencies in that testing were as follows –

    - The Firm used the work of the issuer's IA, and retested IA's work for certain important controls over the inventory process. The issuer's IA identified multiple exceptions in its control testing, including exceptions at many of the locations selected for testing. The Firm failed to sufficiently evaluate whether the exceptions that IA had identified were control deficiencies that individually, or in combination, were material weaknesses. Specifically, there was no rationale in the work papers for treating only certain of the exceptions as control deficiencies that would be accumulated for evaluation. Further, the Firm failed to evaluate the extent to which the identified control deficiencies would be applicable to the issuer's locations that were not tested.

    - The Firm failed to sufficiently test the design and operating effectiveness of certain important controls. In certain instances, the Firm relied on walkthrough procedures that did not include testing of relevant control attributes. In other instances, the Firm failed to determine whether the review controls operated at a level of precision that would prevent or detect material misstatements, as the Firm's testing generally was limited to inquiring of management, observing signatures as evidence of review, and/or otherwise verifying that certain actions performed as part of the control had occurred. In addition, for certain review controls, the Firm failed to test controls over the completeness and accuracy of the system-generated information used in the performance of the controls.

- The Firm concluded that journal entry controls were operating effectively throughout the year, but this conclusion was not sufficiently supported, as the Firm's testing of the control requiring review and approval of the journal entries was limited to observing signatures as evidence of review.

- The Firm's procedures to update its testing of certain controls between its interim testing and year end were limited to inquiry, despite the varying degrees of risk associated with controls and deficiencies noted during its interim testing.

- The Firm relied on the controls noted above as compensating controls for a number of control deficiencies it had identified; however, this reliance was not justified in light of the nature and extent of exceptions identified for these controls and the deficiencies in testing described above.

- The Firm failed to sufficiently test controls over, and perform sufficient substantive procedures related to, inventory. Specifically –

    - The Firm failed to identify and test any controls over certain of the issuer's significant inventory processes.

    - The Firm failed to sufficiently test the design and operating effectiveness of certain automated controls. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the applications were configured to meet certain relevant control objectives and, with respect to certain automated controls, it tested only one scenario even though various scenarios were reasonably possible. Further, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested the accuracy of an important system calculation.

    - The Firm failed to sufficiently test the effectiveness of certain of the issuer's review controls, as the Firm's testing was limited to inspecting evidence of sign-off and approval without testing the precision of the underlying review.

- o There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the level of reliance on controls that it applied in its substantive testing was appropriate in light of the exceptions identified in its control testing, and the exceptions identified in its testing of the compensating controls it identified (which are discussed above).

- o The Firm failed to perform substantive procedures to test the capitalized labor and overhead component of finished goods inventory.

- o The Firm performed inventory testing procedures within two of the issuer's divisions; however, it failed to test a significant remaining portion of inventory, which aggregated to nine times the Firm's established materiality level and included work-in-process inventory as well as inventory held at divisions not tested. In addition, although the Firm performed confirmation procedures at an interim date to test the existence of inventory held off-site, the Firm did not update this testing, or perform other procedures, to test the existence of this inventory at year end.

- o The Firm failed to obtain a sufficient understanding of the issuer's information system relevant to financial reporting for one significant location. As a result, it failed to identify that the issuer used spreadsheets, and not the inventory application, as the primary system for maintaining inventory pricing and quantities, and failed to test any controls over this process at this location.

- The Firm placed unwarranted reliance on certain important system-generated data and reports related to the recording and processing of inventory, and/or the period-end financial reporting process, as it failed to perform sufficient procedures as follows –

- o The Firm concluded that Information Technology General Controls ("ITGCs") for change management related to certain systems were ineffective. The Firm tested a sample of changes to certain of these systems; however, this approach did not address the risk of unauthorized changes to the systems. In addition, for another of these systems, the Firm relied on management's review of certain data produced by the system, as well as the results of its substantive procedures, for evidence of the reliability of the system. The substantive procedures, however, did not address the risk of unauthorized changes to configurable settings, and the reviews did not operate at a sufficient level of precision to do so.

- o The Firm determined that ITGCs over two payroll applications were ineffective, and its testing of application controls over the completeness and accuracy of data produced by these applications was insufficient. Specifically, for one control, the Firm's test consisted of high-level analytical procedures, but these procedures provided no information regarding the operation of the control. For the other control, the Firm's tests were too limited to cover the entire period of reliance on the systems' data and reports.

- o The Firm determined that ITGCs over three systems used for inventory and/or revenue processes at certain locations where it performed testing were ineffective. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had, in determining the scope of its testing and its ability to rely on data and controls related to these processes, considered that other locations that were not tested used these same systems.

A.4. Issuer D

In this audit, the Firm failed to sufficiently test the valuation of the issuer's long-lived assets, which consisted of groups of assets at multiple, separate locations. The issuer calculated earnings before interest, taxes, depreciation, and amortization ("EBITDA") by location and selected the locations with negative EBITDA both in the current period and a recent period for further evaluation for potential impairment. The Firm failed to identify that the issuer's analysis –

- Did not include certain expenses in the EBITDA calculations for most of the locations, and

- Did not identify for further evaluation certain locations for which the current level of EBITDA was insufficient to cover the recorded amount of the asset group over its remaining useful life.

A.5. Issuer E

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its opinion on the financial statements –

- The Firm failed to sufficiently test whether the issuer's lease arrangements met the requirements for sales-type lease accounting under generally accepted accounting principles ("GAAP"). Specifically, for lease arrangements that the issuer evaluated by comparing the present value of future minimum lease payments to the fair value of the leased equipment, the Firm recalculated the fair value of the leased equipment based on the issuer's standard price list and specific terms in the respective leases, but failed to use market information in its testing. For lease arrangements that the issuer evaluated by comparing the lease term to the economic life of the leased equipment, the Firm failed to evaluate the appropriateness of the issuer's inclusion of equipment that customers returned before the expiration of the respective lease in the economic life calculation.

- The Firm failed to perform procedures, beyond reading a management-prepared memo and inquiring of management, to test the residual value of returned leased equipment.

A.6. Issuer F

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The Firm failed to perform sufficient tests of controls and substantive procedures related to the issuer's allowance for loan losses ("ALL"). Specifically –

- The Firm failed to perform sufficient procedures to test the issuer's controls over loan grading. The Firm's selection of a sample of loans for testing these controls was not designed in a manner that would be expected to produce a representative sample, as it excluded loan relationships below a monetary threshold from the population subject to testing.

- The Firm failed to test controls over the issuer's process for reviewing appraisals on real estate that served as collateral for impaired loans.

- For certain impaired loans that the Firm selected for testing, the Firm failed to test the specific reserves, beyond inquiring of management.

- The Firm failed to sufficiently test the design and operating effectiveness of controls over, and failed to perform sufficient substantive procedures to test, the calculation of the general and unallocated components of the ALL as follows –

  - For its substantive testing, the Firm chose to review and test management's process for estimating the unallocated and general ALL reserves. The Firm's work papers included various inconsistencies and anomalies related to these two components of the ALL, such as the use of the same loss factors for categories of loans with different loan grades representing different loss risks, the exclusion of the fourth quarter losses from the determination of the ALL assumptions, and the decision that no reserves were needed for loans in several loan grades representing varying degrees of credit risk. While the Firm inquired of management and performed certain procedures to obtain corroboration of management's explanations of certain of the inconsistencies and anomalies, the Firm failed to evaluate whether management's decisions related to these inconsistencies and anomalies were appropriate.

  - The recorded ALL included reserves for specific loans, certain components calculated based on loss percentages, and an unallocated reserve. The size of the unallocated reserve fluctuated significantly during the year and, at year end, the unallocated reserve was approximately two times the Firm's established level of materiality. The Firm, however, limited its procedures to test the unallocated reserve to evaluating the overall directional consistency of that component of the reserve.

  - The Firm failed to perform procedures beyond inquiry to test controls over the issuer's analysis of historical losses in its loan portfolio, which the issuer used to develop a critical assumption used in the ALL calculation.

  - The Firm's testing of controls over the process for charging off loans, or designating them as non-accrual status, was not performed at an appropriate level of precision. Specifically, the testing was limited to verifying management's approval of a form, and did not include an evaluation of the timeliness of the charge-offs and changes to non-accrual status.

- o The Firm failed to sufficiently test a review control consisting of the periodic analysis of the ALL, as its testing was limited to reviewing the issuer's board and committee meeting minutes, and noting that a memorandum summarizing the analysis was sent to the board and to management.

A.7. Issuer G

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The Firm's failures related to control and substantive testing with respect to the ALL and investment securities.

- Regarding the Firm's procedures related to the ALL –

  - o The Firm failed to sufficiently test an important control over the issuer's loan grading. The issuer used an external party to review the loan grades assigned by loan officers. For those loans where the external party recommended a different loan grade, the Firm failed to evaluate whether the information management used to assign the final loan grade supported that grade.

  - o The Firm failed to sufficiently test the issuer's review controls over the ALL calculation. Specifically, the Firm's procedures were limited to reading meeting minutes and obtaining evidence of approval, without evaluating the underlying review process or the basis for the approval.

  - o The Firm failed to identify and test controls over certain data and reports the issuer used to calculate the ALL, and did not test the completeness and accuracy of those data and reports.

  - o The Firm failed to sufficiently test specific reserves for impaired loans. Specifically, the Firm failed to evaluate the appropriateness of the methods and reasonableness of the assumptions the issuer's appraisers used to determine collateral values for certain impaired loans that the Firm selected for testing. In addition, for certain of those impaired loans, the issuer calculated a specific reserve using a lower value for the underlying collateral than the appraised value, and the Firm failed to perform procedures beyond inquiry to evaluate the reasonableness of the issuer's discount to the appraised value.

- The Firm failed to perform procedures, beyond reading issuer memos and performing high-level analytical procedures, to test certain types of reserves within the ALL.

- Regarding the Firm's testing related to the issuer's investment securities –

    - The Firm failed to obtain an understanding of the specific methods and/or assumptions underlying fair value measurements that were obtained from pricing services or other third parties and used in the Firm's testing of the fair value measurements of certain financial instruments without readily determinable fair values ("hard-to-value financial instruments").

    - For the valuation of investment securities, the Firm relied on controls at an external service organization, but these controls did not address the valuation of the securities, and the Firm failed to identify and test other controls over that assertion.

A.8. Issuer H

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The issuer had multiple lines of business at numerous locations, each with different accounting systems. The Firm selected several ELCs for testing, and its strategy for the financial statement audit included significant reliance on these ELCs. The Firm's testing of the operating effectiveness of the ELCs was not sufficient, as these procedures did not include determining whether the ELCs operated at a level of precision to prevent or detect a material misstatement. Specifically, the testing was limited to inquiring of management, verifying that certain actions performed as part of the control had occurred, reading documents prepared in connection with the operation of the controls, comparing certain data used in the controls to other issuer-supplied data, and reading IA's reports. In addition, the Firm failed to sufficiently test controls over the issuer's process for updating the monthly financial forecasts prepared by each location that were used in the ELCs. Specifically, the Firm's testing was limited to verifying that the issuer prepared the monthly forecasts and comparing the data used in the ELCs to the reporting packages submitted by each location.

A.9. Issuer I

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

- The Firm identified a control deficiency related to the issuer's process for reserving for credit memos. The Firm failed to appropriately evaluate the severity of this control deficiency in the following respects –

  - The Firm's analysis focused on the actual amount of the error, rather than the magnitude of the potential misstatement, and this analysis included only credit memos issued during an approximately two-month period after year end. The Firm failed to consider whether additional credit memos should be contemplated, as nearly half of the credit memos included in the two-month period had been issued more than two months after the sale date.

  - The Firm identified reviews occurring at periodic management meetings as a compensating control; however, the Firm failed to determine whether this control was designed and operating at a level of precision to prevent or detect material misstatements related to credit memos.

- The Firm failed to perform sufficient procedures to evaluate the collectability of a significant receivable owed by a former customer. The issuer and this former customer had filed lawsuits against each other, and the receivable was significantly past due. The Firm's procedures to evaluate collectability consisted of inquiring of management, obtaining management representations, and obtaining letters from lawyers involved in the two lawsuits. While both lawyers indicated that the litigation was in the early stages, the lawyer involved in the suit to collect the receivable indicated that another lawyer would be in a better position to assess the probability of a favorable outcome. The Firm failed to perform procedures to contact this other lawyer.

- The issuer records the majority of its revenue based on delivery data received electronically from a large number of vendors. The Firm failed to test controls over, or otherwise test, the completeness and accuracy of those data. Further, the Firm failed to evaluate the implications of the significant differences between the delivery date and the invoice date for most of the transactions selected during tests of controls of unbilled revenue.

A.10. Issuer J

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

- The Firm's testing related to the issuer's accrual for advertising and promotions ("A&P") expenses was insufficient. Specifically –

    - The Firm failed to identify and test any controls over the accrual for A&P expenses not yet paid ("A&P calculation") for one of the issuer's business lines. Although the Firm identified certain management review controls, its testing did not establish that these controls operated at a level of precision to address the A&P calculation.

    - The Firm failed to determine the types and timing of advertising and promotional programs that the issuer had offered in the current and prior periods in order to evaluate whether it was reasonable to calculate the assumptions underlying the accrual based on historical activity. Specifically, the issuer's A&P calculation relied on two key assumptions: the amount of advertising and promotional discounts as a percent of sales, and the time lag between when the issuer offered such discounts and when the customer claimed them. The issuer calculated both of these assumptions using historical A&P activity, even though the types of A&P discounts offered varied over time, and the time lag had varied significantly from period to period.

- The issuer had implemented a strategy of growth through acquisitions, and intangible assets resulting from business combinations represented the majority of the issuer's total assets. During the year, the issuer acquired two businesses, one for which the purchase price was approximately 35 times the Firm's established level of materiality. The Firm identified an ELC, which consisted of a review of quarterly financial statements, that it asserted provided assurance over the issuer's process for recognizing assets acquired and liabilities assumed in business combinations. The Firm failed to sufficiently test this control, as its procedures were limited to obtaining evidence that such reviews had occurred, without evaluating whether the control operated at a level of precision that would prevent or detect material misstatements related to business combinations. The Firm also asserted that its substantive testing of the assets acquired and liabilities assumed was dual-purpose in nature and provided evidence of the operation of other controls in this area. There was no evidence in the audit documentation, and no persuasive other evidence, however, that the Firm's tests included procedures to evaluate the design and operating effectiveness of these other controls.

A.11. Issuer K

In one audit of this issuer, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its opinion on the financial statements –

- The issuer concluded that no reserve was required for certain tax assessments by a foreign jurisdiction. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the technical merits of the issuer's tax position.

- The Firm failed to maintain control over the cash confirmation process, as it allowed a courier service hired by the issuer to deliver the requests for confirmation.

In the next year's audit of the issuer, the Firm failed to obtain sufficient appropriate audit evidence to support its opinion on the effectiveness of ICFR. The issuer made two significant acquisitions during the year, and the Firm identified a significant risk related to business acquisitions. The Firm, however, failed to test any controls over the accounting for business acquisitions.

A.12. Issuer L

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

- Sales orders from the issuer's customers are frequently customized and sales prices fluctuate based upon underlying commodity prices. To address controls over pricing, the Firm tested certain review controls, but it failed to sufficiently test the operating effectiveness of these controls. Specifically, the Firm failed to identify and test any controls over the completeness and accuracy of reports that the issuer used when performing the review controls, and the Firm failed to determine whether the review controls operated at a sufficient level of precision to detect material errors related to pricing.

- The Firm failed to sufficiently test controls over the period-end financial reporting process. Specifically –

  - The Firm failed to determine whether certain review controls that it selected for testing operated at a level of precision that would prevent or detect material misstatements.

  - The Firm failed to identify and test any controls over the completeness and accuracy of certain of the reports used in the operation of certain of these controls.

  - There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the failure of personnel at certain of the issuer's locations to follow the issuer's policy regarding account reconciliations represented a control deficiency.

  - The Firm inappropriately used the work of an issuer compliance group in testing certain of these controls. Specifically, this group had a direct reporting relationship to a member of management in the accounting department who was responsible for or performed certain of the controls in the period-end financial reporting that the compliance group tested.

A.13. Issuer M

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

- The Firm failed to perform sufficient procedures with respect to the valuation of long-lived assets. The issuer concluded that it did not need to test any of its long-lived assets for impairment despite the fact that certain asset groups had incurred current and historical operating losses. To test the issuer's conclusion, the Firm developed a high-level cash flow analysis; however, the analysis contained errors. Had the errors been corrected, the analysis would have identified an additional indicator of potential impairment for one of the asset groups that the Firm should have evaluated in performing its tests.

- The Firm failed to sufficiently test the issuer's controls over the evaluation of the potential impairment of long-lived assets. Specifically, the Firm failed to evaluate whether the issuer's controls were designed to identify all relevant indicators of potential impairment. For one control, which involved management's review for indicators of potential impairment, the Firm's testing was limited to inquiry of management, and the Firm did not obtain evidence that the other controls it tested were precise enough to identify indicators of potential impairment.

A.14. Issue N

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinions on the financial statements and on the effectiveness of ICFR. The issuer used two service organizations to process customer transactions and used certain of the data and reports produced by these service organizations in the performance of several of the controls that the Firm selected for testing. The Firm also used certain of these data and reports in its control and substantive testing of cash and investments, payables to customers, and certain receivable accounts, and in its testing of controls related to certain significant services the issuer provided to its customers. The Firm failed to perform sufficient procedures to test the completeness and accuracy of these data and reports as follows –

- The Firm obtained a service auditor's report on controls at one of the service organizations, but this report addressed controls over only some of the reports produced by the service organization. The Firm failed to test, or otherwise obtain evidence of the design and operating effectiveness of, controls over the completeness and accuracy of the other data and reports identified above.

- The Firm failed to perform procedures to obtain evidence regarding the design and operating effectiveness of any of the controls at the other service organization.

A.15. Issuer O

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

- The Firm failed to sufficiently test controls over the issuer's process for determining the ALL –

  - For certain categories of loans, the Firm failed to sufficiently test the operating effectiveness of review controls over loan grading, as the Firm's procedures did not include testing the effectiveness of the issuer's review. Specifically, the Firm limited its testing of the operating effectiveness of the control over risk rating to verifying that a review of the ratings was performed and reviewing the recommended changes to the ratings, without testing the precision of the review.

  - The Firm failed to sufficiently test the operating effectiveness of certain reconciliation and review controls over the calculation of the general component of the ALL, as the Firm failed to evaluate whether the controls operated at an appropriate level of precision to detect a material misstatement.

  - The Firm failed to select and test controls over certain significant inputs into the calculation of the general component of the ALL, including loan origination dates, loan product types, and historical default data.

- The issuer identified a deficiency in a control over the risk-rating of loans in one of the issuer's loan portfolios. The Firm failed to sufficiently evaluate the severity and implications of this deficiency, as follows –
  - The Firm failed to consider whether the existence of this deficiency should have affected the extent of its control testing for other loan portfolios, as the same control applied to all of the issuer's portfolios.
  - The Firm's evaluation of the severity of this deficiency failed to include consideration of other control deficiencies, unadjusted audit differences related to the issuer's ALL and weaknesses identified by the issuer's primary regulator related to the issuer's identification of credit deterioration.

A.16. Issuer P

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinion on the effectiveness of ICFR. The issuer used an external service organization to execute and process transactions related to the issuer's available-for-sale ("AFS") securities, and to maintain custody of those securities. The issuer used information provided by this service organization to record the transactions and to record the fair value of the securities in its general ledger. The Firm failed to obtain an understanding of controls at the service organization, and the Firm failed to test, or otherwise obtain evidence of, the operating effectiveness of controls related to the existence of the AFS securities and the completeness and accuracy of information provided by the service organization.

A.17. Issuer Q

In this audit, the Firm failed to perform sufficient procedures to assess the remaining estimated useful lives of certain intangible assets. The Firm's analysis relied on procedures performed in a prior year when the assets were acquired. In that year, however, the Firm had failed to sufficiently test the reasonableness of the estimated useful lives of the assets, as it failed to evaluate, beyond inquiry of management and the issuer's specialist, contrary evidence consisting of historical annual customer retention data that differed significantly from the retention assumptions the issuer used to value and amortize the assets.

A.18. Issuer R

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its opinion on the effectiveness of ICFR. The Firm selected for testing certain review controls over the valuation of AFS securities, but failed to sufficiently test these controls. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained an understanding of the review procedures performed by management, evaluated the criteria management used to identify price changes for investigation, and determined whether pricing exceptions were appropriately resolved.

A.19. Issuer S

In this audit, the Firm failed to sufficiently test the valuation of certain types of the issuer's derivative contracts. The Firm tested these derivative contracts by selecting a sample and independently calculating the fair values of the selected contracts. For most of the derivative contracts in the sample, the issuer's fair value measurement was significantly higher than the fair value measurement the Firm determined; the total of the differences approximated 50 percent of the recorded value of those contracts. The Firm, however, failed to evaluate the implications of these significant differences.

A.20. Issuer T

In this audit, the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying fair value measurements that were obtained from pricing services or other third parties and used in the Firm's testing of certain hard-to-value financial instruments.

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 processes related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following five areas (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining clients, including the application of the Firm's risk-rating system; (4) processes related to the Firm's use of audit work that the Firm's foreign affiliates perform on the foreign operations of the Firm's U.S. issuer audit clients; and (5) the Firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to weaknesses in quality control. 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 APPENDIX B OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX C

THE INSPECTION PROCESS FOR ANNUALLY INSPECTED FIRMS

The inspection process is designed, and inspections are performed, to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. This appendix describes the inspection process for those annually inspected firms that have multiple practice offices and a national office structure. While this appendix describes the general inspection process applied in the 2011 inspections of these firms, the process was customized to each firm's inspection, bearing in mind the firm's structure, past inspection observations, observations during the course of the 2011 inspection, and other factors. Accordingly, procedures described in this Appendix, while generally applicable to annual inspections, may not have been applied, or may not have been applied fully, in the inspection of any individual firm, and additional procedures, not described in this appendix, may have been applied in the inspection of an individual firm.

The inspection process included reviews of aspects of selected issuer audits completed by the inspected firm. These reviews were intended both to identify deficiencies, if any, in those aspects of the audits and to determine whether those deficiencies indicated weaknesses or defects in the firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain quality control processes of the firm that could be expected to affect audit quality.

1. Review of Selected Audits

Inspections include reviews of aspects of selected audits of financial statements and ICFR. For each audit selected, the inspection team reviewed certain of the issuer's SEC filings. The inspection team selected certain aspects of the audits for review and inspected the engagement team's work papers and interviewed engagement personnel regarding those aspects. The inspection team also analyzed potential adjustments to the issuer's financial statements that were identified during the audit but not corrected. For certain selected engagements, the inspection team reviewed written communications between the firm and the issuer's audit committee and, for some engagements, the inspection team interviewed the chairperson of the issuer's audit committee.

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 was allowed the opportunity to provide a written response to the comment form.

2. Review of Firm Management and Monitoring Processes Related to Audit Quality Control

The inspection team's review of a firm's system of quality control was intended to provide a basis for assessing whether that system was appropriately designed and implemented to achieve the goal of conducting audits that are in compliance with applicable standards. This review included an evaluation of the firm's ability to respond effectively to indications of possible defects in its system of quality control.

2.a. Review of Management Structure and Processes, Including the Tone at the Top

Procedures in this area were designed to focus on (a) how the firm's management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance, and (b) whether actions and communications by the firm's leadership – the "tone at the top" – demonstrate a commitment to audit quality. The inspection team interviewed members of the firm's leadership to obtain an understanding of any significant changes in the firm's approach to, and processes for, its management, including the mechanisms, formal or informal, that assess, monitor, or affect audit performance. The inspection team also reviewed significant management reports and documents, as well as information regarding financial metrics and the budget and goal setting processes that the firm uses to plan for, and evaluate the success of, its business.

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

Procedures in this area were designed to focus on (a) whether the firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the firm; (b) the firm's processes for allocating its partner resources; and (c) the accountability and responsibilities of the different levels of firm management with respect to partner management. The inspection team interviewed members of the firm's management and also reviewed documentation related to certain of these topics. In addition, the inspection team's interviews of audit partners included questions regarding their responsibilities and allocation of time and the interviews of firm management included the performance of partners being inspected, the evaluation and compensation process, any disciplinary actions, and any situations where a client requested a change in the lead audit partner. In addition, the inspection team reviewed a sample of partners' personnel files, including files of partners who resigned or took early retirement and partners who had significant negative inspection results from recent internal and PCAOB inspections.

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

The inspection team selected certain issuer audits to (a) evaluate compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the client and (b) observe whether the audit procedures were responsive to the risks identified during the process.

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

The inspection team reviewed the firm's policies and procedures related to its supervision and control of work performed by foreign affiliates on the operations of U.S. issuer clients, reviewed available information relating to the most recent foreign affiliated firms' internal inspections, interviewed members of the firm's leadership, and reviewed the U.S. engagement teams' supervision and control procedures concerning the audit work that the firm's foreign affiliates performed on a sample of audits. In some cases, the inspection team also reviewed, on a limited basis, certain of the audit work performed by the firm's foreign affiliates on the foreign operations of U.S. issuer clients.

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

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

Procedures in this area were designed to identify and assess the monitoring processes that the firm uses to monitor audit quality for individual engagements and for the firm as a whole. The inspection team interviewed members of the firm's management and reviewed documents regarding how the firm identifies, evaluates, and responds to possible indicators of deficiencies in audit performance, including internal inspection findings, PCAOB inspection observations, restatements, and litigation. In addition, the inspection team reviewed documents related to the design, operation, and evaluation of findings of the firm's internal inspection program. The inspection team also reviewed certain audits that the firm had inspected and compared its results to those from the internal inspection.

2.e.ii. Review of Response to Weaknesses in Quality Control

The inspection team reviewed steps the firm has taken in the past several years to address possible quality control deficiencies. The inspection team then assessed the design and evaluated the effectiveness of the processes identified. In addition, the inspection team conducted focused inspections of audits of certain issuers whose audits had been reviewed during previous PCAOB inspections of the firm to ascertain whether the audit procedures in areas with previous deficiencies had been improved.

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

The inspection team assessed policies, procedures, and guidance related to aspects of the firm's independence requirements and its consultation processes and the firm's compliance with them. In addition, the inspection team reviewed documents, including certain newly issued policies and procedures, and interviewed firm management to consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

APPENDIX D

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.[10/]

[10/] In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.

Ernst & Young LLP
5 Times Square
New York, New York 10036-6530
Tel: 212-773-3000
www.ey.com

November 15, 2012

Ms. Helen Munter
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

Response to Part I of the Draft Report on the 2011 Inspection of Ernst & Young LLP

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") regarding Part I of the Draft Report on the 2011 Inspection of Ernst & Young LLP (the "Report").

We have thoroughly evaluated the matters described in Part I – *Inspection Procedures and Certain Observations of the Report* and have taken actions to address findings in accordance with PCAOB standards and our policies.

There are certain findings in the Report where we believe the totality of the audit work performed supported our opinions on the financial statements, taken as a whole, and on the effectiveness of internal control over financial reporting. Notwithstanding this view, we have amended certain of our policies, procedures or practices to respond to the Board's observations and better align our prospective audit performance with our shared objectives.

The PCAOB's inspection process assists us in identifying areas where we can continue to improve audit quality. We respect and benefit from this process as it aids us in fulfilling our responsibility to make all aspects of our auditing and quality control processes of the highest quality in the interests of investors and the capital markets.

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,

Stephen R. Howe, Jr.
Managing Partner

G. Thomas Hough
Vice-Chairman Assurance Services