1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8433
www.pcaobus.org

Report on

2013 Inspection of Ernst & Young LLP
(Headquartered in New York, New York)

Issued by the

Public Company Accounting Oversight Board

August 14, 2014

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. 104-2014-143

PCAOB Release No. 104-2014-143

2013 INSPECTION OF ERNST & YOUNG LLP

Preface

In 2013, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Ernst & Young LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.C of this report (which also contains additional information concerning the PCAOB inspections generally). Overall, the inspection process included reviews of portions of selected issuer audits completed by the Firm. These reviews were intended to identify whether deficiencies existed in those portions of the inspected audits, and whether such deficiencies indicated defects or potential 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.

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report, portions of Appendix B, and Appendix C. Appendix B includes the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the Firm's system of quality control, those discussions also could eventually be made public, but only to the extent the Firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures[1] for the inspection from December 2012 through October 2013. The inspection team performed field work at the Firm's National Office and at 33 of its approximately 69 U.S. practice offices.

A. Review of Audit Engagements

The 2013 inspection of the Firm included reviews of portions of 56 audits performed by the Firm and a review of the Firm's audit work on one other issuer audit engagement in which the Firm played a role but was not the principal auditor. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix C to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in the references to the auditing standards in this sub-Part, unless the lack of compliance with these standards

[1] For this purpose, the time span for "primary procedures" includes field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. The time span does not include inspection planning, which may commence months before the primary procedures, and inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which generally extend beyond the primary procedures.

is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

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

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

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

The audit deficiencies that reached this level of significance are described below.

---

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

A.1. Issuer A

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

- The issuer held inventory and generated revenue at numerous locations, where certain types of routine transactions were initiated and processed. In planning and performing its tests of controls, the Firm assumed that a monitoring control that operated throughout the issuer's two business units was designed effectively and implemented uniformly, and the Firm therefore reduced the number of locations at which it would test the transaction-level controls. The monitoring control was intended to assess the operation of various transaction-level controls at each of the issuer's locations. The Firm failed to (1) sufficiently test this monitoring control and (2) consider the implications of evidence that appeared inconsistent with its assumption that the monitoring control was designed effectively and implemented uniformly. Specifically –

    - The Firm used the work of the issuer's compliance group, which tested the monitoring control as well as certain transaction-level controls (including controls that addressed fraud risks) and information technology general controls ("ITGCs") for certain applications. The Firm determined that the compliance group had moderate objectivity, as the group reported to management. The Firm concluded it could use the compliance group's work to the extent that it did based on the assumption that internal audit ("IA") would perform reviews of the quality of that work. The Firm failed to re-evaluate this conclusion in light of the fact that (1) IA did not review the testing of the monitoring control for one of the issuer's two business units and (2) there was no evidence in the audit documentation that IA had reviewed the testing of the monitoring control for the issuer's other business unit. (AS No. 5, paragraph 18; AU 322, paragraph .10)

    - For one of the issuer's two business units, the Firm's procedures for testing the design of the monitoring control were limited to evaluating the compliance group's testing of the control without evaluating the effectiveness of the monitoring control itself. (AS No. 5, paragraph 42)

- o The procedures performed by the compliance group to test the monitoring control consisted of sampling from the controls that had been subject to the monitoring control; the testing of the sampled items was limited to obtaining evidence that certain activities that constituted part of the transaction-level control or the monitoring control had occurred, including obtaining evidence of sign-off by the control owner; comparing certain amounts to the general ledger; and inquiring of management. The Firm failed to identify that these procedures were insufficient, as the procedures did not include evaluating whether the monitoring control operated uniformly and at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and B10)

- o The monitoring control was designed to operate only once or twice per year at each location. The issuer and the Firm identified a number of deficiencies in transaction-level controls that were subject to the monitoring control. The Firm failed to consider whether the monitoring control's failure to detect these deficiencies should have had an effect on the Firm's conclusion that the monitoring control was operating effectively. (AS No. 5, paragraph 48)

- In designing its testing approach, the Firm assumed that all of the issuer's various instances of two important information technology ("IT") applications were identically configured. The Firm's audit approach involved testing ITGCs over the issuer's change management process with respect to these applications, to support the Firm's conclusions regarding controls over these applications. For one application, the Firm failed to test any controls over the issuer's change management process. For the other application, the Firm failed to test any controls designed to determine that changes were appropriately deployed to all instances of the application, as its testing was limited to a control that addressed only the risk that changes could be made to an individual instance of the application without approval. (AS No. 5, paragraph 39)

- The Firm identified a control, consisting of a review of monthly operating results, as a compensating control for certain of the transaction-level control deficiencies. The Firm failed to sufficiently test this control, as it did not perform any procedures to determine whether the control addressed the risks intended to be addressed by the controls that were deficient. In addition, the Firm's procedures were limited to observing evidence of reviewer sign-off, testing reports for clerical accuracy, and comparing certain amounts to quarterly Securities and Exchange Commission ("SEC" or "the Commission") filings, without evaluating whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and 68)

- The Firm identified a fraud risk related to the timing of revenue recognition. The Firm failed to perform sufficient procedures related to the issuer's revenue and accounts receivable. Specifically –

    - Related to the recording of revenue, the Firm failed to identify and test any controls that addressed the accuracy and completeness of the sales terms, and related customer and pricing information, entered into the issuer's IT applications. In addition, the Firm failed to test any controls over the accuracy and completeness of certain system-generated reports that the issuer used in the performance of certain controls related to revenue and accounts receivable. (AS No. 5, paragraph 39)

    - The Firm failed to perform sufficient substantive procedures to test accounts receivable. The Firm designed its procedures – including sample sizes – based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of the monitoring control that are discussed above. As a result, certain of the sample sizes that the Firm used to test accounts receivable were too small to provide sufficient evidence. In addition, based on the unsupported level of control reliance, the Firm tested the existence of accounts receivable six months before year end; while the Firm performed roll-forward procedures to extend its conclusion to year end, these procedures were not sufficient under the circumstances. (AS No. 13, paragraphs 16, 18, 37, and 44; AU 350, paragraphs .19, .23 and .23A)

- The Firm concluded that ITGCs at a significant business acquired by the issuer during the year were effective and that the Firm could rely on certain application and IT-dependent manual controls in its testing of the opening balance sheet of the acquired business. That conclusion was based on the Firm's view that it had identified a control that compensated for a known deficiency in an ITGC of the acquired business related to periodic review of user access. The control that the Firm viewed as compensating for the deficiency, however, related only to the initial approval and later removal of user access and did not compensate for the known deficiency. The Firm designed its substantive procedures based on a level of control reliance that, because of the control deficiency, was not supported. As a result, the Firm's testing of accounts receivable and inventory at the acquired business, which was limited to testing at various interim dates rather than the date of acquisition and did not include procedures to extend conclusions to the date of acquisition, was insufficient. (AS No. 13, paragraphs 16, 18, and 44)

- The Firm failed to perform sufficient procedures to test the labor and overhead costs included within inventory and the related controls. Specifically –

    - The Firm failed to identify and test any controls that addressed (1) whether the types of labor and overhead costs that were included in inventory were appropriate and (2) the issuer's determination of normal production capacity, which was a factor in determining the rates used to allocate overhead costs to inventory. (AS No. 5, paragraph 39)

    - The Firm selected for testing a control that consisted of the review of the capitalization of inventory variances; however, the Firm's procedures were limited to observing evidence of reviewer sign-off, testing the clerical accuracy of the underlying calculations, and comparing certain amounts to supporting documents. The Firm also stated that certain of its substantive tests were dual-purpose in nature and provided evidence of the effectiveness of this control. The Firm, however, failed to test, through any of its procedures, whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and B9)

- o The Firm's primary substantive tests related to the labor and overhead costs included in inventory were analytical procedures. These analytical procedures, however, were limited to comparisons of certain current-period data to the corresponding data for prior quarters and the prior year. These procedures provided little to no substantive assurance because the Firm failed to establish appropriate expectations, as it did not obtain evidence as to why the amounts used for comparison could be expected to be predictive of the issuer's current-period costs. (AU 329, paragraphs .05, .13, and .14)

- o The Firm failed to test whether the types of labor and overhead costs that were included in inventory were appropriate. In addition, the Firm failed to evaluate whether the assumed normal capacity for each production facility, which the issuer used in determining the allocation of overhead costs to inventory, was reasonable. (AS No. 14, paragraph 30; AU 342, paragraph .11)

A.2. Issuer B

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

- The Firm identified one important control over the accounting for business combinations; however, it failed to sufficiently test this control. Specifically, the Firm's procedures were limited to (1) obtaining evidence that the issuer's board of directors approved the significant acquisition that had occurred during the year, including the related fairness opinion and valuation and (2) obtaining the fairness opinion and a report by a subcommittee of the board regarding the valuation methodology. The Firm, however, failed to test, through any of its procedures, whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The issuer recorded revenue, including from arrangements that consisted of one or more deliverables, from sales and leases of products and software, and from services. The issuer allocated certain elements of multiple-element arrangement consideration to the deliverables using best estimate of selling price ("BESP"). The Firm identified a fraud risk related to improper revenue recognition. The Firm failed to perform sufficient procedures related to revenue, deferred revenue, and accounts receivable for one of the issuer's segments. Specifically –

  - For certain controls selected for testing, the Firm's procedures were limited to one or more of the following: inquiring of management, observing evidence of reviewer sign-off, recalculating certain amounts, testing reports and reconciliations for clerical accuracy, reading certain documents, and comparing certain items to supporting documents and/or the general ledger. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

  - The Firm failed to identify and test any controls over the completeness of a system-generated report used in the performance of the one control over deferred revenue that it tested. In addition, for certain other controls over revenue and accounts receivable, the Firm failed to test the completeness of the population from which it selected samples of transactions for testing. (AS No. 5, paragraph 39; AU 350, paragraph .39)

  - The Firm failed to identify and test any controls over the issuer's establishment of BESP, and failed to perform any substantive procedures related to the determination of the issuer's BESP. (AS No. 5, paragraph 39; AS No. 14, paragraph 30)

  - The Firm selected two controls that it considered to be responsive to the fraud risk it identified related to revenue, and the Firm used the work of IA that tested these controls. For one of these controls, however, the Firm did not test IA's work, and for the other control, the Firm reperformed only a small portion of IA's work. (AS No. 5, paragraph 19; AU 322, paragraphs .20 and .26)

- o The Firm failed to perform sufficient procedures to test whether the issuer's sales-type lease transactions met the criteria to be reported as revenue pursuant to Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 840, *Leases*. Specifically –

  - ▪ The Firm failed to perform any testing related to the fair value of leased equipment at the inception of the lease, other than by comparing the method for calculating the fair value to that used in the prior year. (AS No. 14, paragraph 30)

  - ▪ The Firm failed to adequately test the residual value of leased equipment in that it (1) failed to consider the actual percentage of lease arrangements that resulted in a sale or lease renewal and (2) limited its testing related to the value of returned equipment to a sample of only one item. In addition, the Firm failed to test the completeness of the population from which it selected the returned equipment for testing. (AS No. 14, paragraph 30; AU 350, paragraph .24)

- The Firm failed to perform sufficient procedures related to inventory and inventory reserves. Specifically –

  - o For certain controls selected for testing, the Firm's procedures were limited to one or more of the following: inquiring of management, observing evidence of review or other activities that were part of the controls, recalculating certain amounts, testing the clerical accuracy of certain reports and reconciliations, and comparing certain amounts to supporting documents and/or the general ledger. In addition, for certain of these controls, the Firm stated its substantive testing provided evidence of the effectiveness of these controls; however, the Firm failed to test, through any of its procedures, whether any of the controls operated at a level of precision that would prevent or detect material misstatements. Further, the Firm failed to identify and test any controls over the accuracy and completeness of system-generated reports that the issuer used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, 44, and B9)

- o The Firm's testing of inventory was insufficient. Specifically, the Firm's procedures included test counts at certain locations, but it made all of its selections for testing from the issuer's system-generated inventory count listing, and did not select any items for testing from the inventory on hand. In addition, the Firm failed to test whether the issuer's cycle-count procedures addressed that (1) all inventory items were counted and (2) the cycle counts occurred as frequently as planned. (AU 331, paragraph .11)

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

A.3. Issuer C

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

- The issuer initiated and processed transactions related to inventory, revenue, and accounts receivable at a large number of production locations. In planning its tests, the Firm assumed that the flows of transactions at these locations, as well as the controls over these transactions (including ITGCs and the underlying IT application controls), were uniform, and, as a result, the Firm selected its samples to test these controls by considering all transactions subject to the controls at these locations as a single population, without considering the risks associated with the locations. The Firm's assumption was not supported, as the Firm failed to (1) gain a sufficient understanding of the flow of transactions and controls over these transactions in order to conclude that the flows of transactions and controls were uniform and (2) consider the implications of evidence that appeared inconsistent with that conclusion. Specifically, the Firm based its assumption on walking through the flow of transactions at a small percentage of the locations, inquiring of management, and relying on knowledge gained through its prior-year testing, despite the issuer's integration during the year of a significant number of recently acquired locations. In addition, at the locations where the Firm performed walkthroughs, the Firm identified a number of differences in the operation of certain controls as compared to the issuer's documentation, but it failed to evaluate the effect of these differences on its approach. (AS No. 5, paragraphs 34, B10, and B11)

- The Firm identified exceptions in its testing of certain controls over the period-end financial reporting process, accounts receivable, and revenue at locations that it selected for testing. The Firm failed to evaluate the effect of these exceptions on its conclusion regarding the effectiveness of the issuer's controls, other than by noting that the frequency of the exceptions was acceptable, without having defined a tolerable rate of exceptions. (AS No. 5, paragraph 48)

- Related to revenue and accounts receivable, the Firm selected for testing certain automated controls over users' access to the issuer's IT applications' functions that allow changes to invoices and customer information, but failed to sufficiently test these controls. Specifically, the Firm tested these controls for two of the multiple IT applications that the issuer used to process revenue transactions; the Firm, however, failed to determine whether these controls operated effectively for any of the other corresponding applications at other locations. (AS No. 5, paragraphs 42 and 44)

- The issuer used system-generated reports in the performance of certain controls that the Firm selected over inventory, revenue, and accounts receivable. The Firm failed to identify and test any controls over the accuracy and completeness of the information included in these reports. (AS No. 5, paragraph 39)

- The Firm designed its substantive procedures – including sample sizes – to test certain accounts receivable and inventory based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, certain of the Firm's sample sizes related to accounts receivable and inventory were too small to provide sufficient evidence. In addition, based on the unsupported level of control reliance, the Firm tested the existence of accounts receivable six months before year end; while the Firm performed roll-forward procedures to extend its conclusion to year end, these procedures were not sufficient under the circumstances. (AS No. 13, paragraphs 16, 18, 37, 43, and 44; AU 350, paragraphs .19, .23, and .23A)

A.4. Issuer D

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

- The Firm identified a fraud risk related to revenue from contracts accounted for using the percentage-of-completion ("POC") method, but failed to perform sufficient tests related to revenue from such contracts. Specifically –

  - The Firm selected for testing certain controls that consisted of reviews of the estimates to complete and certain related reports for POC contracts, but failed to identify and test any controls over the accuracy and completeness of the system-generated data and reports that the issuer used in the performance of these controls. The Firm also selected for testing a control that consisted of reviews of the estimates to complete performed by a group outside of the relevant segment; this control was designed to supplement the controls noted above. The Firm failed to sufficiently test this control, as its procedures were limited to inquiring of management and verifying that the group met to discuss the estimate. (AS No. 5, paragraphs 39, 42, and 44)

  - The Firm designed its procedures – including its approach for selecting POC contracts to test – based on a level of control reliance that was excessive due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the POC contracts that the Firm selected to test did not provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AS No. 15, paragraphs 22 and 23)

- o The issuer used certain assumptions in making adjustments to the estimated revenue from certain POC contracts; the Firm's procedures to test these assumptions, however, were insufficient. Specifically, the Firm's procedures were limited to inquiring of management and observing that certain revenue adjustments agreed to supporting documentation and the general ledger, without evaluating the reasonableness of the underlying assumptions. (AU 342, paragraph .11)

- The Firm selected for testing certain controls over pension benefits that consisted of (1) the review by issuer personnel of service-auditor reports regarding controls at relevant service organizations, (2) the review of pension plan investments, and (3) the review by issuer personnel of certain data used to determine pension liabilities and the resolution of any discrepancies in the data; however, the Firm's testing of these controls was insufficient. Specifically, the Firm's procedures were limited to inquiring of management, reading the service-auditor reports, and obtaining evidence that reviews and certain other actions performed as part of the controls had occurred, such as management meetings and communications between the issuer and the issuer's actuary, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. The Firm also stated that certain of its substantive testing provided evidence of the effectiveness of these controls. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and B9)

A.5. Issuer E

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

- The Firm identified a fraud risk related to one of the issuer's insurance reserves. The Firm's procedures with respect to the valuation of this reserve, as well as certain other insurance reserves and policy claim liabilities, were insufficient. Specifically –

  - o The Firm failed to identify and test any controls that were intended to determine that the assumptions that the issuer used in estimating the insurance reserves were reasonable. (AS No. 5, paragraph 39)

  - o The Firm selected controls over these insurance reserves and policy claim liabilities that consisted of analyses of the reserves and liabilities and related trends, as well as the review of these analyses; however, its testing of these controls was insufficient. Specifically, the Firm's testing was limited to obtaining and inspecting the analyses and, for some of these analyses, noting that variances were discussed; and attending meetings that constituted part of the operation of one of these controls. The Firm's testing did not address the criteria used by the control owners to identify matters for investigation or ascertain the nature of the review procedures performed; therefore, the Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain system-generated reports that the issuer used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, and 44)

  - o The issuer determined that there were errors in the insurance reserves during the year and in prior years and identified a related significant control deficiency. The Firm failed to sufficiently evaluate this control deficiency, as its evaluation focused only on the actual amount of the errors rather than the potential misstatement. In addition, the issuer identified other control exceptions and deficiencies through its review of controls. The Firm, however, failed to evaluate the effect of these exceptions and deficiencies, in combination with the significant deficiency, on its conclusion about the effectiveness of ICFR. (AS No. 5, paragraphs 48, 62, and 63)

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

- The Firm's approach for substantively testing the insurance reserves was to review and test the issuer's process. The Firm, however, failed to evaluate the reasonableness of the issuer's assumptions, and failed to test the accuracy and completeness of data that the Firm used in its testing, other than by tracing the data to system-generated reports that the Firm had not tested. (AS No. 15, paragraph 10; AU 342, paragraph .11)

- The Firm's procedures to test the valuation of goodwill for one of the issuer's reporting units were insufficient. The issuer performed an annual analysis of the possible impairment of goodwill. The Firm failed to sufficiently evaluate the reasonableness of certain significant assumptions, including revenue projections and future planned cost savings, that the issuer used in that analysis, as the Firm's procedures were limited to inquiring of management; reading an issuer-prepared report, which detailed planned cost savings; and obtaining an organizational chart that reflected the transfer of certain costs from the reporting unit. (AU 328, paragraphs .26, .28, and .31)

- The Firm's procedures related to the valuation and disclosure of certain of the issuer's investment securities without readily determinable fair values ("hard-to-value securities") were insufficient. Specifically –

  - The Firm selected for testing one control over the valuation of hard-to-value securities, which consisted of the comparison of the issuer's recorded price to a price obtained from the issuer's custodian and the review of the results of this comparison. The Firm's procedures were limited to inquiring of management, reading the issuer's documentation, and obtaining evidence of review. The Firm failed to evaluate whether this control or any of the issuer's other controls addressed (1) whether the prices were determined in conformity with GAAP and (2) whether the securities were appropriately classified within the fair value hierarchy. (AS No. 5, paragraphs 39, 42, and 44)

- o The Firm failed to sufficiently test the issuer's disclosure of the hard-to-value securities as level 2 in the fair value hierarchy set forth in FASB ASC Topic 820, *Fair Value Measurement*, as the Firm failed to obtain an understanding of the specific methods and assumptions underlying the fair value measurements that were obtained from the issuer's custodian, including whether the securities were valued using significant inputs that were observable or unobservable. (AU 328, paragraphs .26, .40, and .43)

- For one of the issuer's segments, the Firm's testing related to revenue recognition, for which it had identified a fraud risk, was insufficient. Specifically –

  - o The Firm failed to identify and test any controls over the accuracy and completeness of system-generated reports that the issuer used in the performance of certain controls that the Firm tested. (AS No. 5, paragraph 39)

  - o The Firm's substantive testing of certain of the revenue for this segment was insufficient, as the Firm did not test the data underlying most of the items in the sample of revenue transactions that it selected. (AU 350, paragraph .25)

A.6. <u>Issuer F</u>

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

- The issuer generated revenue at numerous locations, where certain types of routine transactions were initiated and processed. The Firm identified a fraud risk related to revenue. In planning its tests of controls, the Firm – based on its testing of certain entity-level controls and its assumption that certain entity-level controls that were tested in the prior year continued to operate effectively – limited the number of locations at which it tested controls over revenue and accounts receivable. This reduction in the scope of the Firm's testing was not supported, as (1) the issuer's locations had different processes, applications, and controls, and (2) the two entity-level controls that the Firm selected for testing addressed only a portion of the assessed risks of material misstatement regarding revenue. Specifically, one of the entity-level controls that the Firm selected for testing consisted of a review of adjustments to revenue, but the design of this control did not include automated adjustments to revenue, which represented the majority of such adjustments. The other entity-level control addressed only certain of the important inputs that the issuer used in calculating revenue. In addition, the Firm did not identify and test any controls at the location level that addressed assessed risks of material misstatement regarding the valuation and occurrence of revenue and related accounts receivable that were not addressed by these entity-level controls. (AS No. 5, paragraphs 39 and B11)

- The Firm's procedures related to certain insurance reserves were insufficient, as follows –

  - The Firm selected for testing certain controls that consisted of (1) the performance and/or review of analyses and reconciliations and (2) the review of certain system-generated data and reports; however, the Firm failed to sufficiently test these controls. Specifically, the Firm's procedures were limited to one or more of the following: comparing certain data to supporting documentation, inquiring of management, and obtaining evidence that certain activities (including meetings and reviews that constituted all or part of the controls) had occurred. In performing these procedures, however, the Firm failed to obtain an understanding of, and evaluate, the specific procedures that the control owners performed and failed to perform procedures to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

  - The Firm identified and tested a control over the accuracy and completeness of a system-generated report that was important to the operation of certain controls that the Firm tested over these reserves. The Firm failed to evaluate whether this control addressed the risk that underlying loss data was incomplete or inaccurate. In addition, the Firm failed to identify and test any controls over the assumptions that the issuer's actuary used in its calculation of a component of the reserves. (AS No. 5, paragraph 39)

  - The issuer used a service organization to administer certain claims and to produce data that the issuer's actuary used to calculate one of these reserves. The Firm failed to obtain evidence of the operating effectiveness of controls over the accuracy and completeness of the data for the nine-month period not covered by the service auditor's report that the Firm obtained. In addition, in its substantive testing, the Firm failed to test the accuracy and/or completeness of certain types of data produced by the service organization for use in calculating one of the reserves. (AS No. 5, paragraphs B18 and B24; AU 324, paragraph .15)

- The Firm designed its substantive procedures – including sample sizes – to test certain insurance reserves, revenue, accounts receivable, and related contractual allowances based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, certain of the Firm's sample sizes were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.7. Issuer G

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

- The issuer held inventory at numerous locations, where certain types of routine transactions were initiated and processed. In planning and performing its tests of controls, the Firm assumed that controls over inventory, accounts receivable, and revenue were designed and implemented uniformly at substantially all locations. Based on this assumption, the Firm reduced the number of locations selected for testing. The Firm and the issuer identified multiple control deficiencies, as well as exceptions, related to the same controls at several of the locations tested, but the nature of these control deficiencies and exceptions was not the same at each location. These results indicated that the Firm's assumption of uniform controls was incorrect and, therefore, the extent of the Firm's testing of the controls was insufficient. (AS No. 5, paragraphs 48 and B10)

- For certain of the control deficiencies noted above, the Firm identified two compensating controls that consisted of (1) quarterly certifications at the location level and (2) monthly operational reviews; however, the Firm's testing of these controls was insufficient. Specifically, for the certification control, the Firm's procedures were limited to inspecting evidence of sign-off by the control owner. For the review control, the Firm's procedures were limited to comparisons of current-period amounts to prior-period amounts. Further, the Firm failed to identify and test any controls over the accuracy and completeness of the system-generated reports used in the performance of the review control. (AS No. 5, paragraphs 39, 42, 44, and 68)

- The Firm identified inappropriate access to the issuer's IT applications that processed inventory, accounts receivable, and revenue transactions, and concluded that the access controls over those applications were ineffective. With respect to certain controls that were affected by this deficiency, the Firm identified compensating controls; however, the effectiveness of these controls was also called into question by the inappropriate access to the IT applications that gave rise to the control deficiency. In addition, the Firm failed to consider the effect of this control deficiency on the effectiveness of certain other controls that were also dependent on those applications. (AS No. 5, paragraphs 65 and 68)

- The issuer engaged an external party ("the consultants") to perform its testing of controls over inventory, accounts receivable, and revenue. The Firm used the work of these consultants to a greater extent than was appropriate, because (1) the Firm failed to consider in its evaluation of the consultants' objectivity that the consultants reported to a member of management in the accounting department and (2) the extent of the Firm's testing of the consultants' work was insufficient to enable the Firm to make an evaluation of the overall quality and effectiveness of the consultants' testing, as the Firm's testing was limited to reperforming only a very small portion of that work. (AU 322, paragraphs .10, .24, and .26)

- The Firm's procedures to test controls over inventory were insufficient. Specifically –
  - o The Firm selected for testing controls that related to the calculation and review of standard costs and inventory reserves; the Firm, however, failed to sufficiently test these controls. Specifically, the Firm limited its procedures to one or more of the following: inquiring of management, observing evidence of reviewer sign-off, comparing certain amounts to prior-year amounts, and recalculating and comparing certain amounts to supporting documents. The Firm failed to evaluate the review procedures performed as part of the operation of the controls; therefore, the Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)
  - o Certain of the issuer's inventory was subject to periodic cycle counts; however, the Firm's procedures to test controls over the cycle-count process were insufficient. Specifically, the Firm's testing was limited to observing one inventory cycle count, reading inventory cycle-count instructions, observing sign-offs on a small number of cycle-count reports, and determining that the cycle-count variances on those reports were adjusted in the issuer's system. The Firm failed to evaluate the review procedures performed as part of the operation of these controls; therefore, the Firm failed to evaluate whether the controls addressed the assessed risk of misstatement. (AS No. 5, paragraphs 42 and 44)
- The Firm failed to test any controls over the accuracy and completeness of the system-generated information that the issuer used in the performance of certain controls that the Firm tested over inventory, accounts receivable, and revenue. (AS No. 5, paragraph 39)

- The Firm designed its substantive procedures – including sample sizes – based on a level of reliance on controls that was excessive due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, certain of the sample sizes that the Firm used to test inventory valuation were too small to provide sufficient evidence. In addition, based on the unsupported level of control reliance, the Firm tested the existence of accounts receivable six months before year end; while the Firm performed roll-forward procedures to extend its conclusion to year end, these procedures were not sufficient under the circumstances. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

- The Firm failed to sufficiently test controls over the issuer's accounting for income taxes. Specifically, the Firm's procedures to test certain controls, which consisted of the performance of income tax calculations and the review of these calculations and related disclosures, were limited to inquiring of control owners and observing evidence of reviewer sign-off. In addition, the Firm stated that certain of its substantive tests were dual-purpose in nature and provided evidence of the effectiveness of these controls. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and B9)

A.8. Issuer H

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

- The issuer accounted for software and services revenue (1) using vendor-specific objective evidence ("VSOE") for multiple-element arrangements, (2) applying POC contract accounting for arrangements requiring significant customization, and (3) using a time-and-materials method of accounting for certain contracts. The issuer also sold software licenses and post-contract support ("PCS") separately. The Firm identified a fraud risk related to improper revenue recognition. The Firm's testing related to the issuer's revenue was deficient in the following respects –

- o Regarding the issuer's VSOE analysis, the Firm failed to identify and test any controls over (1) the completeness of the population of transactions included in the analysis, (2) the accuracy and completeness of the data used in the analysis, and (3) the consistency of the prices charged for certain elements for which the documentation that the issuer used to prepare the analysis did not include a set price. In addition, in its substantive testing, the Firm failed to otherwise test the completeness of the population of transactions included in the issuer's analysis. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)

- o Regarding the issuer's POC and time-and-materials contracts, the Firm failed to identify and test any controls over (1) the accuracy of the reported time used to calculate the revenue to be recognized and (2) the appropriateness of the rates for time and materials that were used in the calculations. In addition, in its substantive testing, the Firm failed to otherwise test the accuracy and completeness of the reported time that was used in the calculations, other than by comparing the data to other system-generated data that the Firm had not tested. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)

- o The Firm failed to identify and test any controls that addressed whether (1) the invoiced rates for PCS were consistent with customer contracts and (2) recognition of software license revenue did not precede the delivery of the software. (AS No. 5, paragraph 39)

- o The Firm selected a sample of sales contracts for testing and identified certain customer-acceptance provisions within those contracts. The Firm failed to evaluate the effect of these provisions on the recognition of revenue. In addition, the Firm failed to evaluate whether the issuer's control that consisted of the review of sales contracts was designed and operated to identify and appropriately consider such provisions. (AS No. 5, paragraphs 42, 44, and B8; AS No. 14, paragraph 30)

- The issuer amortized the majority of its definite-lived intangible assets using accelerated methods. The Firm failed to identify and test any controls over the issuer's amortization of definite-lived intangible assets. (AS No. 5, paragraph 39)

- The Firm's procedures related to the issuer's accounting for income taxes were insufficient. Specifically –

    - The Firm selected for testing one control over the issuer's accounting for income taxes; however, the Firm's procedures to test that control were insufficient. Specifically, the Firm's procedures were limited to inquiring of management and observing signatures as evidence of review. The Firm also documented that certain of its substantive procedures were dual-purpose in nature and provided evidence of the effectiveness of this control. The Firm, however, failed to test, through any of its procedures, whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42, 44, and B9)

    - The Firm failed to evaluate the reasonableness of the issuer's projected future taxable income and reversals of existing taxable temporary differences that the issuer used to estimate the valuation allowance for deferred tax assets. In addition, the Firm failed to evaluate the reasonableness of the assumptions that the issuer used in determining the recognition of uncertain tax positions, beyond inquiring of management, reading a summary memorandum prepared by management, and clerically testing supporting schedules. (AU 342, paragraph .11)

A.9. <u>Issuer I</u>

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

- The Firm failed to perform sufficient procedures to test controls over the existence of certain equipment, as follows –

    - The issuer held this equipment at numerous locations, where certain types of routine transactions were initiated and processed.

In planning and performing its tests of controls, the Firm assumed that controls over the physical inventory observation process for this equipment were designed and implemented uniformly at all locations, even though it performed walkthrough procedures at only one location. Based on this assumption, the Firm reduced the number of locations selected for testing. The Firm identified a number of control deficiencies or exceptions related to the same controls at several of the locations tested, but the nature of these control deficiencies or exceptions was not the same at each location. These results indicated that the Firm's assumption of uniform controls was incorrect and, therefore, the extent of the Firm's testing of the controls was insufficient. (AS No. 5, paragraphs 48 and B10)

- o The Firm failed to sufficiently evaluate the severity of certain control deficiencies it identified at the locations it selected for testing, as it failed to consider whether the deficiencies existed at the remaining locations in order to assess the magnitude of the potential misstatement resulting from the deficiencies. (AS No. 5, paragraph 63)

- o Certain of the controls that the Firm selected for testing were also identified as compensating controls for the deficiencies in other controls that the Firm had identified; however, the Firm failed to sufficiently test these controls. Specifically, the Firm's procedures were limited to inquiring and observing whether certain of the actions that constituted a part of the controls took place and reconciling certain information between various reports, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform sufficient substantive procedures to test this equipment inventory. The Firm designed its procedures based on a level of control reliance that was not supported due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the Firm's substantive procedures did not provide sufficient evidence about the existence of this equipment. Specifically, the Firm's physical inventory observation procedures for this equipment at year end excluded 98 percent of this equipment, and its other substantive tests consisted of the testing of reconciliations and roll-forward analyses, tests of additions and disposals as of an interim date, physical observation of certain acquired equipment during the second quarter, and comparison of interim and year-end balances. (AS No. 13, paragraphs 16, 18, and 37)

- The Firm selected for testing certain controls consisting of the preparation and review of analyses related to the valuation of goodwill and the accounting for business combinations; however, its tests of these controls were insufficient. Specifically, the Firm's procedures were limited to obtaining evidence that reviews had occurred, which failed to test important attributes of the control. The Firm also stated that certain of its substantive tests were dual-purpose in nature and provided evidence of the effectiveness of these controls. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements related to these processes. In addition, the Firm failed to identify and test any controls over the determination of the estimated useful lives, method of amortization, and potential impairment of intangible assets other than goodwill. (AS No. 5, paragraphs 39, 42, 44, and B9)

A.10. Issuer J

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

- The Firm failed to sufficiently evaluate the reasonableness of certain assumptions that the issuer used in its analysis of the possible impairment of goodwill. Specifically, the Firm's procedures to test the issuer's projected financial information and company-specific risk premium were limited to obtaining supporting schedules, inquiring of management, and performing sensitivity analyses. These procedures were insufficient given that the issuer had failed to meet growth-rate projections in the previous two years. In addition, the Firm failed to take into account available evidence that appeared to be inconsistent with the issuer's assumptions related to its implied control premium. (AS No. 14, paragraph 3; AU 328, paragraphs .26 and .28)

- The Firm failed to evaluate whether the controls that it selected for testing were designed to determine that the Firm's evaluation of definite-lived intangible assets for impairment addressed the requirements of ASC 350, *Intangibles - Goodwill and Other*, including by identifying events or conditions indicating that the assets may not be recoverable. In addition, the Firm's substantive procedures to test the valuation of these intangible assets were insufficient, as the Firm failed to consider certain evidence that indicated the assets may not be recoverable. (AS No. 5, paragraph 39; AU 328, paragraphs .26 and .28)

- The Firm's procedures related to revenue, for which it identified a fraud risk, were insufficient. Specifically –

    - The Firm failed to sufficiently evaluate the severity of a control deficiency that it identified. While the Firm identified compensating controls, it failed to evaluate whether those controls addressed the risks intended to be addressed by the control that was deficient. (AS No. 5, paragraph 68)

    - The Firm failed to test the revenue recognition criteria for an adequate sample of sales transactions. The Firm designed its sample both to test controls and as a substantive test. The Firm, however, determined its sample size based on requirements for control testing, rather than calculating a sample for substantively testing an account with an identified fraud risk, which would have required a larger sample. (AU 350, paragraph .44)

    - For one location, which represented over 10 percent of revenue and for which revenue had grown significantly from the prior year, the Firm failed to perform sufficient procedures to address the identified fraud risk and other risks of material misstatement, as it performed only an analytical procedure that compared the total current-year revenue for the location to the corresponding prior-year amount, with variances investigated only through inquiry. (AS No. 9, paragraphs 11 and 12)

- The Firm failed to perform sufficient procedures related to inventory reserves. Specifically, the Firm failed to identify and test any controls over the accuracy and completeness of certain system-generated reports used in the performance of controls that it tested over inventory reserves, for which it identified a fraud risk. In addition, the Firm used these reports in its substantive tests of inventory reserves, but failed to test these reports. (AS No. 5, paragraph 39; AS No. 15, paragraph 10)

A.11. <u>Issuer K</u>

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. Specifically, with respect to the Firm's testing related to a significant location of the issuer –

- The Firm identified a fraud risk related to an inventory reserve; however, the Firm failed to sufficiently test controls over this reserve. Specifically, the procedures were limited to observing evidence that reviews that were part of the controls had occurred, testing supporting documents for clerical accuracy, comparing current-period assumptions and inventory reserve balances to the corresponding prior-period balances, and comparing information in journal entries to supporting documentation and the general ledger, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the issuer's process included recording manual adjustments to the calculated reserve, but the Firm failed to identify and test any controls over this part of the process. Further, the Firm failed to identify and test any controls over the accuracy and completeness of system-generated data and reports used in the performance of one of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm identified a fraud risk related to revenue recognition, but its procedures related to revenue and accounts receivable for this location were insufficient. Specifically –

    - o The Firm selected for testing a control that consisted of the review of unusual revenue transactions. The Firm's procedures were limited to reading a small number of sales contracts, without evaluating the sufficiency of management's review. In addition, the Firm failed to test whether the control ensured that all unusual revenue transactions were identified. (AS No. 5, paragraphs 42 and 44)

- The Firm also selected for testing certain controls that consisted of reviews of customer returns and the determination and review of related credit reserves. The Firm's procedures were limited to inquiring of management and obtaining evidence that reviews had occurred, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of system-generated data and reports used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

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

- The Firm's planned approach for testing this revenue also included the performance of substantive analytical procedures; however, these analytical procedures provided little to no substantive assurance. Specifically, the Firm failed to develop expectations that were sufficiently precise, as its procedures were limited to comparing certain current-year revenue to the corresponding prior-year amounts and expecting that revenue would increase. In addition, the Firm failed to obtain corroboration of management's explanations for certain differences that exceeded the established threshold. (AU 329, paragraphs .17 and .21)

- The Firm's testing to extend its conclusions on the existence of certain accounts receivable for the three-month period between its interim testing and year end was insufficient. The Firm's procedures were limited to cut-off testing for a sample of transactions, reviewing the issuer's analysis rolling forward the balance from the date of interim testing to the year end, and comparing interim-period amounts to year-end amounts; however, the Firm failed to obtain corroboration of management's explanation for a significant difference that the Firm identified. (AS No. 13, paragraph 45)

- o The Firm failed to test the accuracy and completeness of the data that it used in the performance of certain of its substantive tests of this revenue. (AS No. 15, paragraph 10)

A.12. Issuer L

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

- The issuer generated a significant portion of its revenue from service transactions that were initiated, processed, and recorded by the issuer's IT applications. The Firm's procedures to test controls over services revenue were insufficient. Specifically, the Firm chose not to test ITGCs for the applications that initiated, processed, and recorded service transactions, and also did not test automated controls within those applications. The Firm's procedures were limited to testing certain controls that consisted of the review of daily activity and monthly trends; however, the data used in these controls were generated and processed by the applications whose controls the Firm did not test. (AS No. 5, paragraph 39)

- The Firm's planned substantive procedures to test services revenue and deferred revenue consisted primarily of substantive analytical procedures; however, because of deficiencies in the analytical procedures, they provided little to no substantive assurance. The analytical procedures that the Firm performed were monthly trend analyses, using the data from the applications described above, which the Firm did not substantively test. The expectations that the Firm set were directional in nature, and the Firm's evaluation of the results of these procedures focused only on high-level explanations for fluctuations. (AS No. 13, Note to paragraph 17; AU 329, paragraphs .16, .17, and .21)

A.13. Issuer M

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing one control over the issuer's asset amortization process to address risks associated with the issuer's determination of the amortization method and the issuer's need to re-evaluate the method based on certain events. The Firm, however, failed to identify and test any controls over the accuracy and completeness of the system-generated data that constituted the critical information used in the performance of the control to address these risks. (AS No. 5, paragraph 39)

A.14. Issuer N

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

- The issuer recognized revenue from certain transactions based on the criteria in SEC Staff Accounting Bulletin No. 104, Topic 13.A.3(a), *Revenue Recognition – Bill and Hold Arrangements*. The Firm identified a fraud risk related to these transactions. The Firm's procedures to test the revenue associated with these transactions were insufficient in the following respects –

  - The Firm failed to identify and test any controls that included an evaluation of whether revenue transactions accounted for as bill-and-hold arrangements met certain of the criteria for such accounting treatment. (AS No. 5, paragraph 39)

  - The Firm failed to identify that these transactions did not meet all the criteria required to recognize revenue from bill-and-hold arrangements. In addition, the Firm failed to identify and appropriately address that the issuer had omitted required disclosures related to its use of bill-and-hold accounting for a significant portion of its revenue. (AS No. 12, paragraph 12; AS No. 13, paragraph 13; AS No. 14, paragraph 30)

- The Firm's procedures to test certain components of inventory were insufficient in the following respects –

  - o An important aspect of a control that the Firm selected for testing was a review of the capitalization of labor and overhead variances. The Firm failed to sufficiently test this aspect of the control, as its procedures were limited to comparing amounts to the general ledger and observing evidence of review, without evaluating whether the control operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the system-generated information used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

  - o Based on the unsupported level of control reliance, the Firm performed a significant portion of its testing of the labor and overhead costs included in inventory six months before year end; while the Firm performed roll-forward procedures to extend its conclusion to year end, these procedures were not sufficient under the circumstances. In addition, the roll-forward procedures that the Firm performed were analytical procedures, and the Firm failed to test the accuracy and completeness of certain data used in the performance of these analytical procedures. (AS No. 13, paragraphs 16, 18, 43, and 44; AU 329, paragraph .16)

  - o The Firm also performed analytical procedures to test finished goods inventory at year end. The Firm failed to test the accuracy and completeness of certain data used in the performance of these analytical procedures. (AU 329, paragraph .16)

A.15. <u>Issuer O</u>

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

- The Firm's testing related to the existence of fixed assets, for which a fraud risk was identified, was insufficient in the following respects –

- The Firm used the work of the issuer's IA in its tests of controls and substantive testing related to the existence of fixed assets; however, the Firm used that work to a greater extent than was appropriate given the identified fraud risk and the extent of the Firm's testing of that work. Specifically, the Firm used IA's walkthroughs of certain controls and IA's tests of operating effectiveness of all of the controls that were identified as responsive to the fraud risk, and limited its own testing of the controls to reperformance of a small amount of IA's testing. In addition, the Firm used the work of IA to substantively test the existence of fixed assets, without performing any of its own testing. (AS No. 5, paragraph 19; AU 322, paragraphs .20 and .21)

- One of the controls that the Firm selected for testing consisted of a quarterly review of results of operations, including information related to certain fixed assets. The procedures to test this control were limited to obtaining evidence that the review had occurred and variances were explained, testing the clerical accuracy of certain calculations, and comparing amounts in various documents used in the operation of the control to supporting documentation. The Firm, however, failed to test whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44).

- The Firm failed to identify and test any controls over the development and review of certain budget information that the issuer used in the performance of this control and another control that the Firm selected for testing. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test fixed assets, as a significant portion of the current-year additions to fixed assets was excluded from the testing. (AS No. 13, paragraph 13)

* The Firm's testing related to the completeness and valuation of pension and other post-employment benefits ("OPEB") was insufficient in the following respects –

- o The Firm failed to sufficiently test certain controls that included the review and/or approval of certain actuarial valuation assumptions and data, as the Firm's procedures were limited to obtaining evidence that the review and/or approval had occurred, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. For another control that was designed to be a review of the valuation of a sample of pension assets, the Firm's testing identified that the control owner selected the sample from only one type of asset. The Firm failed to consider whether this approach should affect its conclusion on the effectiveness of the control. (AS No. 5, paragraphs 42 and 44)

- o The issuer used participant data as of the beginning of the year in valuing its pension and OPEB liabilities as of year end. The Firm failed to perform procedures to test the issuer's assertion that there were no significant changes to such data during the year, beyond obtaining a representation from management. (AU 342, paragraph .11)

A.16. Issuer P

The Firm was engaged by the principal auditor of the issuer to perform certain procedures on the financial statements and ICFR of a component of the issuer to support the principal auditor's opinion on the consolidated financial statements and ICFR of the issuer. The Firm failed in the following respects to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit –

- The Firm failed to perform sufficient testing related to the valuation of investment securities. Specifically –

  - o The Firm's procedures to test certain controls over the component's determination of the fair value of investment securities were insufficient. Specifically, the Firm selected certain controls consisting of (1) a review of securities identified by the IT applications as having met certain criteria, (2) a review of exception reports, and (3) a monthly oversight meeting, but its testing of these controls was limited to obtaining evidence of review or reading meeting minutes, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to sufficiently test the completeness of the population subject to the first control described above, as its testing was limited to selecting one security and verifying that the system appropriately identified this security as requiring review. (AS No. 5, paragraphs 42 and 44)

- The Firm's substantive procedures to test the valuation of certain of the component's investment securities were insufficient. Specifically –

  - The Firm selected a sample of these securities for testing, but for certain securities within the Firm's sample, the Firm failed to sufficiently evaluate significant differences between its fair value measurements and those of the component, because it limited its investigation to noting that there were no variances related to other similar securities. (AS No. 14, paragraph 3)

  - For certain types of securities, the component recorded the price it had received from one of several external vendors. The Firm failed to include in its sample any of the securities that had been valued using a price obtained from one of these external vendors, which had provided the prices that the component recorded for a significant amount of investments. (AU 350, paragraph .24)

- The Firm selected for testing several controls that consisted of reviews of various aspects of, or inputs to, the component's allowance related to mortgage loans, including collateral values and changes in credit ratings; however, it failed to sufficiently test these controls. Specifically, the Firm's procedures were limited to reading minutes of certain meetings and obtaining evidence of review and approval, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

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

A.17. Issuer Q

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

- The Firm identified a fraud risk related to the valuation of certain investment securities and a fraud risk related to held-for-sale loans, but its procedures to test certain controls in these areas were insufficient. Specifically, the Firm's testing of these controls was limited to one or more of the following: observing evidence of review; reading issuer-prepared memoranda; comparing certain inputs, data, and assumptions used in the valuation to supporting documentation; and recalculating certain values, without determining that its recalculation constituted a reperformance of the specific actions taken as part of the controls. The Firm stated that certain of its substantive tests were dual-purpose in nature and provided evidence of the effectiveness of these controls. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements related to the valuation of these investment securities and held-for-sale loans. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the system-generated information used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, 44, and B9)

- For the investment securities, the Firm designed its procedures – including sample sizes – based on a level of reliance on controls that was excessive due to the deficiencies in the Firm's testing of controls that are discussed above. As a result, the sample sizes the Firm used to test these investment securities were too small to provide sufficient evidence. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, and .23A)

A.18. Issuer R

In this audit, the Firm failed 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 tests of controls over the issuer's revenue and inventory were insufficient. Specifically, the Firm's procedures to test these controls were limited to obtaining evidence that reviews that constituted all or a part of these controls had occurred, comparing amounts in various documents used in the operation of the controls to other documentation, and/or verifying that certain transactions subject to the control had been appropriately processed. The Firm failed to address the criteria used by the control owner to identify items for investigation and whether specific items that were investigated were appropriately resolved; therefore, the Firm failed to test whether the controls operated at a level of precision that would prevent or detect a material misstatement. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to identify and test any controls over the completeness of certain system-generated data that the issuer used in the performance of controls that the Firm tested over the issuer's revenue and inventory. (AS No. 5, paragraph 39)

- The Firm failed to test controls over, or to substantively test, the accuracy and completeness of certain data and reports that it used in the performance of its substantive tests of revenue and inventory. (AS No. 15, paragraph 10)

A.19. Issuer S

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

- The Firm selected for testing a control that included the determination and review of standard inventory costs and the analysis of variances. The Firm failed to sufficiently test this control for two of the issuer's business units, as its procedures were limited to comparing amounts in a schedule of variances to the general ledger, evaluating the reasonableness of an inventory turnover schedule, and determining in which general ledger accounts labor and overhead costs were accumulated, without evaluating whether the control operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

- The Firm's tests of the labor and overhead costs included in inventory were insufficient. Specifically –
  - The Firm's primary substantive tests related to the labor and overhead costs that were included in inventory were analytical procedures. These analytical procedures were limited to comparisons of certain current-year actual data to annualized, budgeted, and/or prior-year data. These procedures provided little to no substantive assurance because the Firm failed to (1) establish appropriate expectations, as it did not obtain evidence as to why the amounts used for comparison could be expected to be predictive of the issuer's current-period costs and (2) test the completeness of certain data used in these procedures. (AU 329, paragraphs .05, .13, .14, and .16)
  - The Firm failed to test whether the types of labor and overhead costs that were included in inventory were appropriate. (AS No. 14, paragraph 30)
  - The Firm failed to evaluate whether the assumed normal capacity for each production facility, which the issuer used in determining the allocation of overhead, was reasonable. (AU 342, paragraph .11)

A.20. Issuer T

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

- The issuer held investment securities that were valued using models. The Firm's procedures to test certain controls over the valuation of these investment securities, for which it had identified a fraud risk, were insufficient. Specifically –

    - The Firm selected for testing certain controls consisting of the review of the valuation of the investment securities, but failed to sufficiently test these controls. Specifically, the Firm's procedures were limited to inquiring of the control owner, testing the clerical accuracy of valuation models, comparing certain amounts to supporting documents, and/or obtaining evidence that such reviews had occurred, without evaluating whether these controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 42 and 44)

    - The Firm selected for testing a control that involved review by an external party of the valuation of certain investment securities; however, the Firm's procedures to test this control were insufficient. Specifically, the Firm's procedures were limited to obtaining evidence that reviews had occurred and obtaining an understanding of which securities had been reviewed and the methodology employed, without evaluating whether the review was appropriate and satisfied the objectives of the control. In addition, the Firm failed to perform procedures to assess whether the external party had the necessary competence to perform the reviews effectively. (AS No. 5, paragraphs 42 and 44)

    - The Firm failed to identify and test any controls over the accuracy and completeness of certain data used in the performance of these controls. (AS No. 5, paragraph 39)

- The Firm's substantive procedures to test the valuation of the investment securities were insufficient. Specifically, the Firm's procedures to test certain significant inputs and assumptions that the issuer used to develop certain of its fair value estimates were limited to identifying changes in those inputs and assumptions and inquiring of management regarding those changes. The Firm failed to obtain corroboration of management's explanations. (AU 328, paragraphs .28, .31, and .39)

A.21. Issuer U

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. The Firm identified a fraud risk related to the valuation of the issuer's goodwill; the Firm's procedures related to goodwill, however, were insufficient. Specifically –

- The issuer used an external party to perform the annual analysis of the possible impairment of goodwill. The Firm failed to sufficiently test the control consisting of the review of this analysis. Specifically, the Firm's procedures were limited to inquiring of the control owner and observing him compare certain amounts in the analysis to supporting documentation, without evaluating whether the control operated at a level of precision that would prevent or detect material misstatements, including determining whether the control involved an evaluation of the significant assumptions used in the analysis. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to sufficiently test the reasonableness of the projected financial information that the issuer used to determine the amount of the impairment of goodwill for two of its reporting units. Specifically, for certain projected financial information, the Firm's procedures were limited to inquiring of management and comparing the information to the issuer's historical results and current-year projections. For certain other projected financial information, the Firm failed to perform any procedures. (AU 328, paragraphs .26, .28, and .31)

A.22. Issuer V

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR. Specifically, the Firm failed to perform sufficient procedures related to the issuer's most significant type of revenue, as follows –

- The majority of this type of revenue was processed, calculated, and recorded automatically by the issuer's IT applications. The Firm's approach for testing controls over this type of revenue was to test (1) certain controls over the input and transfer of data within the issuer's IT applications, (2) certain ITGCs (related to IT job scheduling), and (3) certain controls consisting of reconciliations or management reviews of an analysis of month over month comparisons for this type of revenue. The Firm failed to obtain evidence that the controls it tested sufficiently addressed the risks related to this type of revenue, as the controls did not address the calculation of the revenue, and the Firm's testing of the reconciliations and management review controls was limited to obtaining evidence that the review occurred. These procedures did not include evaluating whether these controls operated at a level of precision that would prevent or detect material misstatements. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm's substantive testing of this type of revenue consisted of selecting, from accounts receivable as of an interim date, a small sample from two of the several categories of transactions included in this type of revenue. This testing was insufficient, as follows –

  - o The Firm failed to test the other significant categories of this revenue. (AS No. 13, paragraph 9)

  - o Because the Firm selected items to test only from accounts receivable, the Firm's testing did not address other revenue transactions that constituted this revenue. (AU 350, paragraph .17)

A.23. Issuer W

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm's tests of controls over the issuer's recognition of revenue, for which the Firm identified a fraud risk, were insufficient. Specifically, the Firm's procedures to test these controls were limited to inquiring of the control owner, observing the control owner reperform certain aspects of the control, obtaining evidence that reviews had occurred, and testing the clerical accuracy of supporting documents. These procedures failed to address the criteria used by management to identify items for investigation and determine whether specific items that were investigated were appropriately resolved. The Firm also stated that certain of its procedures were dual-purpose in nature and provided evidence of the effectiveness of these controls. The Firm, however, failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the system-generated data used in the performance of these controls. (AS No. 5, paragraphs 39, 42, 44, and B9)

A.24. Issuer X

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. During the year, the issuer acquired a business. The Firm failed to identify and test controls that sufficiently addressed the risks related to the accounting for business combinations, as the period-end financial reporting process controls that it selected did not operate at a level of precision that would prevent or detect material misstatements related to business combinations. (AS No. 5, paragraph 39)

A.25. Issuer Y

The Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had identified and tested any controls over the existence of work-in-process and finished goods inventory for one significant location. In addition, the issuer used system-generated reports that specified which items to count each day as part of its cycle-counting controls; the Firm selected these controls for testing. The Firm, however, failed to identify and test any controls that addressed whether (1) all relevant inventory items were counted and (2) the cycle counts occurred as frequently as planned. (AS No. 5, paragraph 39)

A.26. Issuer Z

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as the Firm's procedures to test controls over the issuer's accounting for business combinations were insufficient. The Firm's procedures to test these controls were limited to inquiring of management, reading certain documents, and comparing certain information that was subject to the controls to supporting documents. These procedures failed to (1) address the criteria used by management to identify items for investigation and (2) determine whether specific items that were investigated were appropriately resolved. In addition, the Firm stated that certain of its substantive procedures were dual-purpose in nature and provided evidence of the effectiveness of these controls. The Firm failed to test, through any of its procedures, whether the controls operated at a level of precision that would prevent or detect material misstatements related to the accounting for business combinations. (AS No. 5, paragraphs 42, 44, and B9)

A.27. Issuer AA

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The Firm selected for testing certain controls over the issuer's accounting for income taxes; however, it failed to sufficiently test these controls. Specifically, the Firm's procedures to test the operating effectiveness of these controls were limited to (1) inquiring of the control owner, (2) obtaining evidence of the control owner's review, and (3) comparing certain information to supporting documentation. These procedures failed to (1) address the criteria used by management to identify items for investigation and (2) determine whether specific items that were investigated were appropriately resolved. Therefore, the Firm failed to evaluate whether the controls operated at level of precision that would prevent or detect material misstatements. (AS No. 5, paragraph 44)

A.28. Issuer BB

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as it failed to sufficiently test the issuer's recorded goodwill impairment loss. Specifically, in connection with testing the measurement of the amount of the goodwill impairment loss, the Firm failed to evaluate the reasonableness of the assumed growth rate and attrition rate that the issuer used in valuing its customer-relationship intangible asset, beyond inquiring of management, reading reports prepared by the issuer's specialists, and comparing these assumptions to assumptions that the issuer had used in prior years. (AU 328, paragraphs .26, .28, and .31)

B. Auditing Standards

Each of the deficiencies described in Part I.A of this report represents circumstances in which the Firm failed to comply with the requirement to obtain sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with applicable accounting principles, and/or for its opinion concerning whether the issuer maintained, in all material respects, effective ICFR. Each deficiency could relate to several applicable provisions of the standards that govern the conduct of audits, including both the paragraphs of the standards that are cited at the end of each description of the deficiency included in Part I.A of this report and one or more of the specific paragraphs discussed below.

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

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

The table below lists the specific auditing standards that are referenced for each deficiency included in Part I.A of this report. See the descriptions of the deficiencies in Part I.A for identification of the specific paragraphs, in addition to those noted above, that relate to the individual deficiencies.

PCAOB Auditing Standards	Issuers
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, R, S, T, U, V, W, X, Y, Z, and AA
AS No. 9, *Audit Planning*	J
AS No. 12, *Identifying and Assessing Risks of Material Misstatement*	N
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	A, B, C, D, E, F, G, I, K, L, N, O, P, Q, and V
AS No. 14, *Evaluating Audit Results*	A, B, H, J, N, P, and S
AS No. 15, *Audit Evidence*	D, E, H, J, K, and R
AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*	A, B, G, and O
AU Section 324, *Service Organizations*	F
AU Section 328, *Auditing Fair Value Measurements and Disclosures*	E, J, T, U, and BB
AU Section 329, *Substantive Analytical Procedures*	A, K, L, N, and S
AU Section 331, *Inventories*	B
AU Section 342, *Auditing Accounting Estimates*	A, D, E, H, O, and S
AU Section 350, *Audit Sampling*	A, B, C, E, F, G, J, K, P, Q, and V

C. Information Concerning PCAOB Inspections Generally Applicable to Annually Inspected Firms

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

C.1. Reviews of Audit Work

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

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[3] as well as a firm's failures to perform, or to perform sufficiently, certain necessary audit procedures. The inspection does not involve the review of all of a firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the

---

[3] 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. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

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

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[4]

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain

---

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

areas of financial statements. Thus, the audit work is generally selected for inspection based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

Inclusion of an audit 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 the issuer of the need for changes to its financial statements or reporting on ICFR, or to take steps to prevent reliance on previously expressed audit opinions.[5]

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

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

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

---

5 An inspection may include a review of the adequacy of a firm’s compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure 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.

assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion may indicate a defect or potential defect in a firm's quality control system.[6] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[7] related firm methodology, guidance, and practices; and possible root causes.

In addition to evaluating the audit work performed on specific audits, inspections include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. The inspection team customizes the procedures it performs with respect to the firm's practices, policies, and processes related to audit quality, bearing in mind the firm's structure, procedures performed in prior inspections, past and current inspection observations, an assessment of risk related to each area, and other factors. The areas generally considered for review include (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining issuer audit engagements, including the application of the firm's risk-rating system; (4) processes related to the firm's use of audit work that the firm's foreign affiliates perform on the foreign operations of the firm's U.S. issuer audits; and (5) the firm's processes for monitoring audit performance, including processes for identifying and assessing

---

[6] Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report does not discuss every audit deficiency the inspection team identified.

[7] An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to defects or potential defects in quality control. A description of the procedures generally applied to these areas is below.

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

Procedures in this area are designed to focus on (a) how 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. To assess this area, the inspection team may interview members of the firm's leadership and review significant management reports and documents, as well as information regarding financial metrics and other processes that the firm uses to plan and evaluate its business.

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

Procedures in this area are designed to focus on (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 distinct from 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 may interview members of the firm's management and review documentation related to certain of these topics. In addition, the inspection team's evaluation may include the results of interviews of audit partners regarding their responsibilities and allocation of time. In addition, the inspection team may review a sample of partners' personnel files.

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

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

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

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

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

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

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

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

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

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

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

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, AND APPENDIX A OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX B

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[8]

---

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

EY
Building a better working world

Ernst & Young LLP
5 Times Square
New York, New York
10036-6530

Tel: +1 212-773-3000
www.ey.com

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

July 24, 2014

Response to Part I of the Draft Report on the 2013 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 2013 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.

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 responsibilities to investors, other stakeholders, and the capital markets generally.

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.

Stephen R. Howe, Jr.
Managing Partner

Frank Mahoney
Vice Chair Assurance Services

APPENDIX C

AUDITING STANDARDS REFERENCED IN PART I

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

AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements		
PLANNING THE AUDIT		
Using the Work of Others		
AS No. 5.18	The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use. Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.	Issuer A

	Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.	
AS No. 5.19	The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.	Issuers B and O
USING A TOP-DOWN APPROACH		
Understanding Likely Sources of Misstatement		
AS No 5. 34	To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives – • Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded; • Verify that the auditor has identified the points within the company's processes at which a misstatement - including a misstatement due to fraud - could arise that, individually or in combination with other misstatements, would be material; • Identify the controls that management has implemented to address these potential misstatements; and • Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.	Issuer C
TESTING CONTROLS		
Selecting Controls to Test		
AS No. 5.39	The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.	Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, Q, R,

		T, V, W, X, and Y
Testing Design Effectiveness		
AS No. 5.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.	Issuers A, B, C, D, E, F, G, H, I, K, N, O, P, Q, R, S, T, U, V, W, and Z
Testing Operating Effectiveness		
AS No. 5.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	Issuers A, B, C, D, E, F, G, H, I, K, N, O, P, Q, R, S, T, U, V, W, Z, and AA
Relationship of Risk to the Evidence to be Obtained		
AS No. 5.48	When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. Note: Because effective internal control over financial reporting cannot, and does not, provide	Issuers A, C, E, G, and I

	absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.	
EVALUATING IDENTIFIED DEFICIENCIES		
AS No. 5.62	The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.	Issuer E
AS No. 5.63	The severity of a deficiency depends on - • Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and • The magnitude of the potential misstatement resulting from the deficiency or deficiencies.	Issuers E and I
AS No. 5.65	Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following – • The nature of the financial statement accounts, disclosures, and assertions involved; • The susceptibility of the related asset or liability to loss or fraud; • The subjectivity, complexity, or extent of judgment required to determine the amount involved; • The interaction or relationship of the control with other controls, including whether they are interdependent or redundant; • The interaction of the deficiencies; and • The possible future consequences of the deficiency. Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range. Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in	Issuer G

	combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.	
AS No. 5.68	The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.	Issuers A, G, and J
APPENDIX B - Special Topics		
Integration of Audits		
AS No. 5.B8	*Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum – • The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud. • Findings with respect to illegal acts and related party transactions. • Indications of management bias in making accounting estimates and in selecting accounting principles. • Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.	Issuer H
AS No. 5.B9	To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.	Issuers A, B, D, G, H, I, Q, W, and Z
Multiple Locations Scoping Decisions		
AS No. 5.B10	In determining the locations or business units at	Issuers A, C,

	which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk. Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.	G, and I
AS No. 5.B11	In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.	Issuers C and F
Use of Service Organizations		
AS No. 5.B18	AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion	Issuer F
AS No. 5.B24	When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If	Issuer F

	management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.	

AS No. 9, Audit Planning		
PLANNING AN AUDIT		
Multi-location Engagements		
AS No. 9.11	In an audit of the financial statements of a company with operations in multiple locations or business units,[13/] the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.	Issuer J
Footnote to AS No. 9.11 [13/] The term "business units" includes subsidiaries, divisions, branches, components, or investments.		
AS No. 9.12	Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include: a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its	Issuer J

	environment;[14/] b. The materiality of the location or business unit;[15/] c. The specific risks associated with the location or business unit that present a reasonable possibility[16/] of material misstatement to the company's consolidated financial statements; d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements; e. The degree of centralization of records or information processing; f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit. Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5[17/] for considerations when a company has multiple locations or business units.	

Footnotes to AS No. 9.12

14/ Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

15/ Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

16/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

17/ Paragraphs B10-B16 of Auditing Standard No. 5.

AS No. 12, Identifying and Assessing Risks of Material Misstatement		
OBTAINING AN UNDERSTANDING OF THE COMPANY AND ITS ENVIRONMENT		
AS No. 12.12	As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.	Issuer N

AS No. 13, The Auditor's Responses to the Risks of Material Misstatement		
RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF AUDIT PROCEDURES		
AS No. 13.9	In designing the audit procedures to be performed, the auditor should: a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk; b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[6/] c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously: (1) To obtain sufficient evidence to support the auditor's control risk[7/] assessments for purposes of the audit of financial statements;[8/] and (2) To obtain sufficient evidence to support the auditor's opinion on	Issuer V

	internal control over financial reporting as of year-end. Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.	
Footnotes to AS No. 13.9 [6/] For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures. [7/] See paragraph 7.b of Auditing Standard No. 8, *Audit Risk,* for a definition of control risk. [8/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.		
AS No. 13.13	*Addressing Fraud Risks in the Audit of Financial Statements*. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.	Issuers N and O
TESTING CONTROLS		
Testing Controls in an Audit of Financial Statements		
AS No. 13.16	*Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.	Issuers A, B, C, D, E, F, G, I, K, N, P, and Q
Footnotes to AS No. 13.16 [12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures. [13/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.		
AS No. 13.17	Also, tests of controls must be performed in the	Issuer L

	audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.[14/] Note*:* When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.	
<u>Footnote to AS No. 13.17</u> [14/] Paragraph 10 of Auditing Standard No. 15, Audit Evidence, and paragraph .16 of AU sec. 329, Substantive Analytical Procedures.		
AS No. 13.18	Evidence about the Effectiveness of Controls in the Audit of Financial Statements. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.	Issuers A, B, C, D, E, F, G, I, K, N, P, and Q
SUBSTANTIVE PROCEDURES		
AS No. 13.37	As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.	Issuers A, B, C, D, E, F, G, I, K, P, and Q

Timing of Substantive Procedures		
AS No. 13.43	Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.	Issuers C and N
AS No. 13.44	In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following: a. The assessed risk of material misstatement, including: (1) The auditor's assessment of control risk, as discussed in paragraphs 32-34; (2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements; (3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period; b. The nature of the substantive procedures; c. The nature of the account or disclosure and relevant assertion; and d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.	Issuers A, C, and N
AS No. 13.45	When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the	Issuer K

	account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.	

AS No. 14, Evaluating Audit Results		
EVALUATING THE RESULTS OF THE AUDIT OF FINANCIAL STATEMENTS		
AS No. 14.3	In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.	Issuers J and P
Evaluating the Presentation of the Financial Statements, Including the Disclosures		
AS No. 14.30	The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements. Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.	Issuers A, B, H, N, and S

AS No. 15, Audit Evidence		
SUFFICIENT APPROPRIATE AUDIT EVIDENCE		
Using Information Produced by the Company		
AS No. 15.10	When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[3/] • Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and • Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.	Issuers E, H, J, K, and R
Footnote to AS No. 15.10 [3/] When using the work of a specialist engaged or employed by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, see Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.		
SELECTING ITEMS FOR TESTING TO OBTAIN AUDIT EVIDENCE		
AS No. 15.22	Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are: • Selecting all items; • Selecting specific items; and • Audit sampling.	Issuer D
AS No. 15.23	The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items in the account being tested, and the evidence	Issuer D

	necessary to meet the objective of the audit procedure.	

AU Section 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements		
ASSESSING THE COMPETENCE AND OBJECTIVITY OF THE INTERNAL AUDITORS		
Objectivity of the Internal Auditors		

AU 322.10	When assessing the internal auditors' objectivity, the auditor should obtain or update information from prior years about such factors as—
	• The organizational status of the internal auditor responsible for the internal audit function, including—
	    • Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
	    • Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.
	    • Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.
	• Policies to maintain internal auditors' objectivity about the areas audited, including—
	    • Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.
	    • Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.
		Issuers A and G

EXTENT OF THE EFFECT OF THE INTERNAL AUDITORS' WORK		
AU 322.20	In making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor considers— *a.* The materiality of financial statement amounts—	Issuers B and O

	that is, account balances or classes of transactions. *b.* The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to these financial statement amounts. c. The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions.**fn 7** As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.	
Footnote to AU 322.20 fn7 For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions.		
AU 322.21	For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.	Issuer O
EVALUTATING AND TESTING THE EFFECTIVENESS OF INTERNAL AUDITORS' WORK		
AU 322.24	The auditor should perform procedures to evaluate the quality and effectiveness of the internal auditors' work,	Issuer G

	as described in paragraphs .12 through .17, that significantly affects the nature, timing, and extent of the auditor's procedures. The nature and extent of the procedures the auditor should perform when making this evaluation are a matter of judgment depending on the extent of the effect of the internal auditors' work on the auditor's procedures for significant account balances or classes of transactions.	
AU 322.26	In making the evaluation, the auditor should test some of the internal auditors' work related to the significant financial statement assertions. These tests may be accomplished by either (*a*) examining some of the controls, transactions, or balances that the internal auditors examined or (*b*) examining similar controls, transactions, or balances not actually examined by the internal auditors. In reaching conclusions about the internal auditors' work, the auditor should compare the results of his or her tests with the results of the internal auditors' work. The extent of this testing will depend on the circumstances and should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the internal audit work being considered by the auditor.	Issuers B and G

AU Section 324, Service Organizations		
THE USER AUDITOR'S CONSIDERATION OF THE EFFECT OF THE SERVICE ORGANIZATION ON THE USER ORGANIZATION'S INTERNAL CONTROL AND THE AVAILABILITY OF AUDIT EVIDENCE		
Assessing Control Risk at the User Organization		
AU 324.15	The user auditor's assessments of control risk regarding assertions about account balances or classes of transactions are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures. In making these assessments, the user auditor should consider the nature, source, and interrelationships among the evidence, as well as the period covered by the tests of controls. The user auditor uses the assessed levels of control risk, as well as his or her understanding of internal control, in determining the nature, timing, and extent of substantive tests for particular assertions.	Issuer F

AU Section 328, Auditing Fair Value Measurements and Disclosures		
TESTING THE ENTITY'S FAIR VALUE MEASUREMENTS AND DISCLOSURES		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AU 328.26	The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06). b. The fair value measurement was determined using an appropriate model, if applicable. c. Management used relevant information that was reasonably available at the time.	Issuers E, J, U, and BB
AU 328.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.	Issuers E, J, T, U, and BB
AU 328.31	Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.	Issuers E, T, U, and BB
AU 328.39	The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, the auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for	Issuer T

	example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency, including whether such information is consistent with management's intent and ability to carry out specific courses of action discussed in paragraph .17.	
Developing Independent Fair Value Estimates for Corroborative Purposes		
AU 328.40	The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement.[fn 6] When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs .28 to .37. Instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate. The auditor also should test the data used to develop the fair value measurements and disclosures as discussed in paragraph .39.	Issuer E
Footnote to AU 328.40 fn 6 See section 329, *Analytical Procedures*.		
DISCLOSURES ABOUT FAIR VALUES		
AU 328.43	The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.[fn 8] Disclosure of fair value information is an important aspect of financial statements. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required under GAAP, some entities disclose voluntary additional fair value information in the notes to the financial statements.	Issuer E
Footnote to AU 328.43 fn 8 See also paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.		

AU Section 329, Substantive Analytical Procedures		
AU 329.05	Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations: a. Financial information for comparable prior period(s) giving consideration to known changes b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data c. Relationships among elements of financial information within the period d. Information regarding the industry in which the client operates—for example, gross margin information e. Relationships of financial information with relevant nonfinancial information	Issuers A and S
ANALYTICAL PROCEDURES USED AS SUBSTANTIVE TESTS		
Plausibility and Predictability of the Relationship		
AU 329.13	It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.	Issuers A and S
AU 329.14	As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas	Issuers A and S

	balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.	
Availability and Reliability of Data		
AU 329.16	Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives: • Whether the data was obtained from independent sources outside the entity or from sources within the entity • Whether sources within the entity were independent of those who are responsible for the amount being audited • Whether the data was developed under a reliable system with adequate controls • Whether the data was subjected to audit testing in the current or prior year • Whether the expectations were developed using data from a variety of sources	Issuers L, N, and S
Precision of the Expectation		
AU 329.17	The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph	Issuers K and L

	.20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.	
Investigation and Evaluation of Significant Differences		
AU 329.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, Evaluating Audit Results.)	Issuers K and L

AU Section 331, Inventories

INVENTORIES		
AU 331.11	In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [Revised, June 1981, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 39.]	Issuer B

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

AU Section 350, Audit Sampling		
SAMPLING IN SUBSTANTIVE TESTS OF DETAILS		
Planning Samples		
AU 350.17	When planning a particular sample, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective. For example, an auditor would not be able to detect understatements of an account due to omitted items by sampling the recorded items. An appropriate sampling plan for detecting such understatements would involve selecting from a source in which the omitted items are included. To illustrate, subsequent cash disbursements might be sampled to test recorded accounts payable for understatement because of omitted purchases, or shipping documents might be sampled for understatement of sales due to shipments made but not recorded as sales.	Issuer V
AU 350.19	The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.[fn 3] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.	Issuers A, B, C, E, F, G, K, P, and Q
Footnote to AU 350.19 [fn 3] Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests		

and sources of evidence.		
AU 350.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.	Issuers A, B, C, E, F, G, K, P, and Q
AU 350.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuers A, B, C, E, F, G, K, P, and Q
Sample Selection		
AU 350.24	Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example, haphazard and random-based selection of items represents two means of obtaining such samples.[fn 4]	Issuers B and P
Footnote to AU 350.24 [fn 4] Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.		
Performance and Evaluation		
AU 350.25	Auditing procedures that are appropriate to the particular audit objective should be applied to each sample item. In some circumstances the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, supporting documentation may be missing. The auditor's treatment of unexamined items will depend on their effect on his evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative procedures that would provide him with sufficient evidence to	Issuer E

	form a conclusion. The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.	
SAMPLE SELECTION		
AU 350.39	Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit. Paragraphs 44 through 46 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.	Issuer B
DUAL-PURPOSE SAMPLES		
AU 350.44	In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of deviations from the prescribed control in the population exceeds the tolerable rate. For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control. The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes. Note: Paragraph 47 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.	Issuer J