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Report on

2014 Inspection of Ernst & Young LLP

(Headquartered in New York, New York)

Issued by the

Public Company Accounting Oversight Board

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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

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2014 INSPECTION OF ERNST & YOUNG LLP

Preface

In 2014, 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.D of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included reviews of portions of selected issuer audits. These reviews were intended to identify whether deficiencies existed in the reviewed work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

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

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures[1] for the inspection from November 2013 to October 2014. 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 inspection procedures included reviews of portions of 56 issuer audits performed by the Firm. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. One of the deficiencies related to auditing aspects of issuer financial statements to which the issuer made substantial adjustments after the primary inspection procedures.[2] In addition, in two of the audits described below, after the primary inspection procedures, the Firm revised its opinion on the effectiveness of the issuer's internal control over financial reporting ("ICFR") to express an adverse opinion.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix D to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every

[1] For this purpose, the time span for "primary procedures" includes field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. The time span does not include (1) inspection planning, which may commence months before the primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which generally extend beyond the primary procedures.

[2] The 2014 inspection did not include review of any additional audit work related to the adjustments.

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

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

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

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.[3]

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[3] 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

The audit deficiencies that reached this level of significance are described in Part I.A.1 through I.A.20, below.

Effects on Audit Opinions

Of the 20 issuer audits that appear in Part I.A, deficiencies in 19 audits relate to testing controls for purposes of the ICFR opinion, and deficiencies in 18 audits relate to the substantive testing performed for purposes of the opinion on the financial statements, as noted in the table below. Of the 18 audits in which substantive testing deficiencies were identified, four audits included a deficiency in substantive testing that the inspection team determined was caused by a reliance on controls that was too high in light of deficiencies in the testing of controls.

	Number of Audits
Deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	17
Deficiencies included in Part I.A related to the financial statement audit only	1
Deficiencies included in Part I.A related to the ICFR audit only	2
Total	20

Most Frequently Identified Audit Deficiencies

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

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firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure 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.

more specific information about the deficiency. The table includes only the six most frequently occurring deficiencies in Part I.A of this report and is not a summary of all deficiencies in Part I.A.

Issue	Part I.A Issuers
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	16 Audits: Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, P, and S
Failure to sufficiently test controls over, or sufficiently test, the accuracy and completeness of issuer-produced data or reports.	13 Audits: Issuers A, B, C, D, E, F, G, H, I, J, K, L, and S
Failure to identify and test any controls that addressed the risks related to a particular account or assertion.	12 Audits: Issuers B, C, D, F, H, J, K, L, M, P, Q, and R
Failure to perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	9 Audits: Issuers A, C, E, F, H, I, J, L, and M
Failure to sufficiently evaluate control deficiencies.	8 Audits: Issuers A, E, F, G, H, K, L, and T
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	7 Audits: Issuers C, F, J, K, M, N, and P

Audit Deficiencies

A.1. Issuer A

In this audit of an oil and gas producer, 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 concluded that important information technology general controls ("ITGCs") over certain applications that (1) processed transactions, including those related to oil and gas properties, related reserves, and depletion, depreciation, and amortization ("DD&A") expense, and (2) were used for financial reporting were ineffective. The ITGC deficiencies consisted of deficiencies in access controls for all of these applications, including issues related to segregation of duties, as well as deficiencies for one of these applications that meant that individuals could access and change underlying data. In performing its evaluation of these ITGC deficiencies, the Firm identified and tested five compensating controls and concluded the deficiencies, individually or in combination, did not rise to the level of a significant deficiency or material weakness. The Firm, however, failed to sufficiently evaluate these compensating controls, as (1) the Firm failed to identify that four of the compensating controls were not designed to prevent or detect misstatements that could be material resulting from the ineffective ITGCs and (2) two of these four controls, as well as the fifth control, were also affected by the ITGC deficiencies. (AS No. 5, paragraph 68)

- The Firm identified a fraud risk related to the possible overstatement of oil and gas reserves and understatement of the impairment of oil and gas properties. The Firm failed to perform sufficient procedures related to oil and gas properties, related reserves, and DD&A expense. Specifically –

    - The Firm selected for testing certain controls related to oil and gas properties, related reserves, and DD&A expense that consisted of the preparation of the reserve estimate; reviews of data, and changes to data, underlying the reserve estimate; reviews of expenses incurred; and the review and approval of certain period-end reports, activities, or analyses. The Firm's procedures to test these controls were limited to one or more of the following: inquiring of issuer personnel, inspecting documents with signatures or other notations that indicated reviews and/or certain other actions performed as part of the controls had occurred, comparing certain data to reports from the applications that were subject to the ITGC deficiencies described above, comparing certain amounts or reconciliations to supporting documents, and testing the mathematical accuracy of certain calculations. Although the Firm understood the nature of the review procedures that the control owners should have performed as part of certain of these controls, the Firm failed, for all of these controls, to ascertain the nature of the review procedures actually performed and to evaluate the specific criteria used by the control owners to identify matters for investigation; 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)

- The Firm failed to sufficiently test controls over the accuracy and completeness of reports and data that the issuer used in the performance of certain of the controls related to the oil and gas properties and related reserves that the Firm tested. Specifically, these controls involved the review of the reports and data; however, the Firm's procedures to test these controls consisted of substantively testing those reports and data, without evaluating the actions performed by the control owners. (AS No. 5, paragraphs 42, 44, and B9)

- The Firm failed to perform sufficient substantive procedures to test (1) DD&A expense, (2) the accuracy and completeness of data that the issuer used to estimate oil and gas reserves, and (3) the future net revenue data that the issuer used in its full cost ceiling test. Specifically, the Firm's procedures were limited to comparing certain amounts to data and reports from the applications for which ITGC deficiencies were identified, as discussed above, and, for DD&A expense, testing the mathematical accuracy of the calculation. (AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures to test the valuation of (1) oil and gas properties included in the issuer's full cost pool and (2) unproved properties excluded from the full cost pool, as follows –

    - The Firm selected for testing (1) additions to the full cost pool that exceeded a monetary threshold, as well as one other addition, and (2) costs relating to the largest unproved properties excluded from the full cost pool. The Firm, however, failed to perform any procedures related to the remainder of these populations, which were multiple times the Firm's established level of materiality and represented the majority of these balances. In addition, for those unproved properties that it did select for testing, the Firm's procedures were limited to inquiry of management. (AS No. 15, paragraph 27; AU 342, paragraph .11)

- The Firm failed to perform sufficient procedures to test the capitalization of certain indirect costs into the full cost pool, as its testing was limited to testing the mathematical accuracy of the calculation of the amounts capitalized and concluding that certain capitalization rates that the issuer used were reasonable, without obtaining evidence to support this conclusion. (AU 342, paragraph .11)

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

  - For certain of these controls that the Firm selected for testing, the Firm's procedures were limited to one or more of the following: inquiring of issuer personnel, inspecting documents with signatures that indicated reviews and/or certain other actions performed as part of the controls had occurred, attending meetings that constituted a part of the controls' operation in order to verify that key personnel attended the meetings, and gathering evidence that journal entries were approved and noting that issuer-prepared schedules were included with each entry. The Firm's testing did not include ascertaining the nature of the procedures performed by the control owners and/or evaluating the criteria used by the control owners to identify matters for investigation; 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)

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

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 –

- For two of the issuer's segments, the Firm failed to perform sufficient procedures related to certain revenue that represented a significant portion of total revenue. Specifically –

  - For one of these segments, the Firm identified a fraud risk related to the timing of revenue recognition. To address the fraud risk, the Firm selected for testing a control that consisted of the review of adjustments to revenue for shipments that were in transit at the end of each period; however, the Firm's testing of this control was insufficient. Specifically, the Firm's procedures were limited to determining that the analysis used in the control had been prepared, inquiring of certain individuals involved in the process, inspecting documents with comments that indicated reviews that were part of the control had occurred, and comparing certain amounts to the general ledger. The Firm, however, failed to sufficiently test an important aspect of the control related to the specific review procedures performed by the control owner, as its procedures to test this aspect were limited to inquiry. (AS No. 5, paragraphs 42 and 44)

  - For this same segment, the Firm selected for testing a control that consisted of the approval of negotiated contract terms, including prices in the contracts that were used to calculate revenue; the Firm, however, failed to test any controls over the consistency of the prices in the issuer's accounting system with the prices in the contracts. (AS No. 5, paragraph 39)

  - For the other segment, which included a category of revenue that was recognized on shipment and another category of revenue that was recognized on delivery, the Firm failed to test controls that sufficiently addressed the risks of material misstatement related to revenue recognition. Specifically, the controls that the Firm identified and tested were limited to (1) a control related to the review of the accounts receivable aging and (2) a control related to the review of the journal entries made to record revenue; neither of these controls addressed the risks related to improper revenue recognition. (AS No. 5, paragraph 39)

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

- For one of the issuer's segments, the Firm failed to perform sufficient procedures related to certain long-lived assets consisting of natural resources that represented a significant portion of the total of such assets. Specifically –

  - The Firm selected for testing a control that consisted of the issuer's annual review of depletion charges related to these long-lived assets; however, the Firm's procedures to test this control were insufficient. Specifically, the Firm failed to identify and test any controls over the accuracy and completeness of certain data that the issuer used in the performance of this control. In addition, the Firm failed to identify and test any controls over the capitalized costs related to these assets. (AS No. 5, paragraph 39)

  - The Firm failed to test the accuracy and completeness of certain system-generated data that it used in its substantive testing of depletion expense, other than by agreeing the data to the general ledger. (AS No. 15, paragraph 10)

- For one of the issuer's segments, the Firm failed to perform sufficient procedures related to property, plant, and equipment that represented a significant portion of the total of such assets. Specifically, the Firm selected for testing two controls that consisted of (1) the approval of capital expenditures and (2) the review of this approval prior to capitalizing the expenditures to property, plant, and equipment. The Firm, however, failed to test an important aspect of these controls that addressed whether the expenditure should have been capitalized. In addition, the Firm failed to identify and test any controls over certain key data and assumptions that the issuer used in its control over calculating depreciation. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to perform sufficient substantive procedures to test certain (1) revenue, (2) costs capitalized to property, plant, and equipment, and (3) costs capitalized to long-lived assets, all of which are discussed above. 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 that the Firm used in its testing were too small to provide sufficient evidence. In addition, for one of the issuer's segments, the Firm failed to test the accuracy and completeness of the population from which it selected its samples for testing revenue. (AS No. 13, paragraphs 16, 18, and 37; AU 350, paragraphs .19, .23, .23A, and .24)

A.3. Issuer C

In this audit of a manufacturer and servicer of complex equipment, 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 –

- For its domestic operations, the issuer recognized revenue using the following methods of accounting, based upon the nature of the underlying transactions: (1) the percentage-of-completion ("POC") method, (2) the completed contract method, and (3) upon shipment of a product or completion of a service. The Firm's testing related to this revenue was insufficient in the following respects –

    - Regarding certain POC revenue, for which the Firm identified a fraud risk related to the estimation of profit rates, the Firm's testing was insufficient, as follows –

        - The Firm selected for testing two controls that consisted of monthly meetings in which issuer personnel reviewed (1) the estimated cost to complete each project and (2) the status of each POC contract; however, the Firm's procedures to test these controls were insufficient. Specifically, these procedures were limited to gathering reports used in the operation of the controls, comparing information between these reports, and attending one meeting for each control. The Firm failed to test whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain, and evaluate, the criteria used to identify items for follow-up and how those items were resolved. In addition, the Firm failed to sufficiently test controls over the accuracy and completeness of the reports that the issuer used in the performance of these controls, as its procedures were limited to the comparisons described above. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform substantive procedures to test certain adjustments, which were based upon revisions to the contracts and the estimates to complete, that the issuer made to profit rates during the year. (AS No. 13, paragraphs 8 and 13; AU 342, paragraph .11)

o The Firm tested certain other revenue recognized using the completed contract method or upon shipment of a product or completion of a service. The Firm identified a fraud risk related to cut-off for both of these types of revenue. The Firm's testing was insufficient, as follows –

- The Firm selected for testing four controls that included the review of reports related to revenue recognized using these methods. The Firm, however, failed to sufficiently test controls over the accuracy and completeness of the reports that the issuer used in the performance of these controls. Specifically, for two of the controls, the Firm failed to identify and test any controls over the accuracy and completeness of reports. For a third control, the Firm's procedures were limited to testing the completeness of the report. For a fourth control, the Firm's procedures were limited to testing the accuracy of the report. (AS No. 5, paragraph 39)

- The Firm failed to identify and test any controls over certain of the revenue recognized using the completed contract method; this revenue was multiple times the Firm's established level of materiality. (AS No. 5, paragraph 39)

- The Firm failed to perform sufficient substantive procedures to test revenue recognized using the completed contract method. Specifically, the Firm selected for testing only contracts whose gross margin exceeded a certain monetary threshold; as a result, the untested amount of this type of revenue exceeded the Firm's established level of materiality and represented almost half of this type of revenue. (AS No. 15, paragraph 27)

- The Firm performed cut-off testing for the completed contract revenue as of an interim date and identified exceptions in its testing. Despite these findings, the Firm used the work of the issuer's internal audit ("IA") group to test cut-off at year end without performing any independent testing, and IA selected only a small sample of items, which was half the size of the sample selected at interim, for which to perform its testing. As a result, the Firm failed to perform procedures to sufficiently address the identified fraud risk. (AS No. 13, paragraphs 8 and 13)

o The issuer recognized certain other revenue upon completion of a service or based on the shipping terms for the product. For this revenue, the Firm identified a fraud risk related to cut-off and another fraud risk related to the valuation of the reserve for loss contracts. The Firm's testing was insufficient, as follows –

- Despite the fact that the issuer provided products and services to support the sales of certain of its products during their operating lives, the Firm failed to identify and test any controls related to evaluating whether these sales represented multiple-element arrangements for revenue recognition purposes. In addition, the Firm failed to perform any substantive procedures to address this issue. (AS No. 5, paragraph 39; AS No. 14, paragraph 30)

- Certain of the issuer's products were sold internationally and had shipping terms pursuant to which title would not pass until the products had been delivered to the customers' locations. The Firm failed to sufficiently evaluate the design of the issuer's control over revenue cut-off, which only operated over shipments during the last five days of the closing period and the first five days of the next period ("the issuer's cut-off period"). Specifically, the Firm failed to evaluate whether the control addressed a critical aspect of the process related to identification of shipments that would be recognized on delivery, which could extend beyond the issuer's cut-off period. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of the report that the issuer used in the performance of this control. (AS No. 5, paragraphs 39 and 42)

- In determining the population of transactions for its substantive testing for cut-off, the Firm included only sales that occurred within the issuer's cut-off period. The Firm did not evaluate whether a different period was needed for those international sales for which title would not pass until the products had been delivered to the customers' locations. In addition, the Firm's testing was limited to a small number of transactions, despite the identified fraud risk. (AS No. 13, paragraphs 8 and 13; AU 350, paragraph .17)

- The Firm's substantive procedures to test the reserve for loss contracts were insufficient, as its procedures were limited to agreeing amounts in the supporting schedules to the general ledger and/or to issuer-prepared calculations, testing the schedules for mathematical accuracy and completeness, and inquiring of the issuer as to whether the ending gross margins for certain contracts were indicative of future gross margins, without testing the reasonableness of this assumption. (AS No. 13, paragraph 13; AU 342, paragraph .11)

- The Firm failed to perform sufficient substantive procedures related to the sale of certain types of products that represented a significant portion of the issuer's revenue, as its procedures excluded revenue that was multiple times the Firm's established level of materiality and was approximately 70 percent of this type of revenue. (AS No. 13, paragraph 37)

- For the issuer's domestic locations, the Firm failed to perform sufficient procedures related to certain inventory. Specifically –

  - The Firm selected for testing certain controls that consisted of the review of standard costs (including burden rates), variances, and inventory balances; however, the Firm's procedures to test these controls were insufficient. Specifically, the Firm's procedures were limited to inquiring of management, inspecting emails that indicated certain reviews had occurred, and comparing certain amounts to supporting documents and/or the general ledger. The Firm failed to test whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain, and evaluate, (1) the nature of the review activities performed, (2) the criteria used to identify items for follow up, and (3) how those items were resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of reports that the issuer used in the performance of certain of these controls. Further, although the controls that the Firm tested addressed aspects of the capitalization rates used, the Firm failed to test any controls that addressed whether the types of labor and overhead costs that were included in inventory were appropriately capitalized. (AS No. 5, paragraphs 39, 42, and 44)

  - The Firm performed substantive tests over the allocation of labor and overhead costs to cost of goods sold; however, the Firm failed to test the completeness of a report that it used in this testing. In addition, the Firm did not perform substantive tests over the labor and overhead costs that were capitalized in inventory. (AS No. 14, paragraph 30; AS No. 15, paragraph 10; AU 342, paragraph .11)

- o Certain of the issuer's inventory was subject to periodic cycle counts, and the issuer used a system-generated report that specified which items to count as part of its cycle-count procedures. The Firm's procedures to test the existence of, and controls over the existence of, this inventory were insufficient. Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency. (AS No. 5, paragraph 39; AU 331, paragraph .11)

A.4. <u>Issuer D</u>

In this audit of a manufacturer, 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. The Firm identified a fraud risk related to improper revenue recognition. For certain business units, the Firm selected a sub-set of locations at which it performed tests of important controls over inventory, revenue, and accounts receivable. The Firm, however, failed to assess the risks of material misstatement associated with the individual locations and use that assessment to determine the locations at which to test these controls. (AS No. 5, paragraph B10; AS No. 9, paragraphs 11 and 12)

- The Firm's procedures for testing certain controls over inventory, revenue, accounts receivable, and the issuer's period-end financial reporting process (including some of the controls noted above) were insufficient.

  - o For one control, consisting of the automated calculation of inventory costs, the Firm's procedures were limited to reviewing the recalculation of one inventory cost. This review, however, was insufficient to support a conclusion that the system was operating effectively to calculate all inventory costs, as the Firm failed to obtain an understanding of, and test, how the system was configured to perform this control. (AS No. 5, paragraphs 42 and 44)

- o For another control that the Firm selected, which involved the matching of invoices, purchase orders, and receipts, the Firm failed to test operating effectiveness. (AS No. 5, paragraph 44)

- o The Firm failed to identify and test any controls over (1) the accuracy of shipping terms, quantities shipped, and shipment dates that were entered into the system and (2) the classification of costs for raw materials inventory. (AS No. 5, paragraph 39)

- o The Firm selected for testing a control over the accuracy of invoice prices; however, in testing this control, it failed to select its samples from the complete population, as it made its selections from a report that included only discounted invoices. (AU 350, paragraph .39)

- o The Firm failed to identify and test any controls over the accuracy and completeness of certain reports that the issuer used in the performance of certain controls that the Firm tested over inventory, revenue, accounts receivable, and the period-end financial reporting process. (AS No. 5, paragraph 39)

- o For certain controls that the Firm considered to be responsive to the fraud risk, the Firm failed to perform procedures to extend its conclusions to year end. For certain other controls, the Firm used inquiry alone to update its interim testing at certain locations to year end, despite the fact that the roll-forward period for these locations was over five months long. (AS No. 5, paragraphs 55 and 56)

- Certain of the issuer's inventory was subject to daily cycle counts, and the issuer used a system that specified which items to count each day as part of its cycle-counting controls. The Firm's procedures to test the existence of, and controls over the existence of, this inventory were insufficient.

Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency. (AS No. 5, paragraph 39; AU 331, paragraph .11)

- The Firm failed to perform sufficient substantive procedures to test accounts receivable and inventory. 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, certain of the sample sizes that 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.5. Issuer E

In this audit of a manufacturer and supplier of components, 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 reduced the number of locations selected for testing based on (1) its assumption that the flows of transactions, information systems, and internal controls were uniform across all locations, and (2) its conclusion that certain entity-level monitoring controls were effective. This reduction in the scope of the Firm's testing was not supported, as follows –

    - o The Firm failed to gain a sufficient understanding of the flow of transactions and controls over the transactions in order to determine whether the flows of transactions and controls were uniform. Specifically, the Firm's basis for its conclusion consisted of (1) its testing of controls at only a small number of locations and (2) for certain other locations, reports from the Firm's foreign affiliates that contained only statements as to which processes were tested. (AS No. 5, paragraphs 34 and B10)

- o The issuer used different instances of two information technology ("IT") applications at many of its locations; each instance represented a separate occurrence of the application that could be configured differently. The Firm assumed that all of these instances were managed by the issuer's data centers, and that the instances were subject to a uniform set of controls. As a result, the Firm limited its testing of the instances of these applications to those locations that it had selected for testing as described above. The Firm, however, failed to obtain any evidence to support its assumption that the issuer's data centers employed a uniform set of controls for each instance of both of these applications. (AS No. 5, paragraphs 42 and 44)

- o For one transaction-level control related to inventory reserves, the issuer and the Firm identified deficiencies at different locations. The Firm failed to consider whether the failure of one of the entity-level monitoring controls to detect these deficiencies should have affected the Firm's conclusion that the entity-level monitoring control was operating effectively. In addition, despite its assumption that the controls were uniform at all locations, the Firm failed to evaluate whether the deficiencies were systemic and should have been evaluated across all locations. (AS No. 5, paragraphs 48 and 65)

- o The Firm failed to identify and test any controls over the accuracy and completeness of reports that the issuer used in the performance of another entity-level monitoring control. (AS No. 5, paragraph 39)

- For an automated control that the Firm tested, which involved the matching of documents prior to the payment of invoices, the Firm's procedures were limited to testing a sample of one transaction for each of three locations, even though the control addressed different types of transactions that involved varying processing mechanisms. In addition, for this control and another automated control, which involved the matching of documents prior to the shipment of products, the Firm failed to test whether the applications' functionality could be modified by the users. (AS No. 5, paragraphs 42 and 44)

- The Firm's substantive testing of inventory and revenue was insufficient, as follows –

  - The Firm performed analytical procedures as an important component of its tests of revenue and inventory; however, these procedures provided little to no substantive assurance. Specifically –

    - The Firm performed analytical procedures to test revenue at certain of the locations that the Firm selected for testing as described above. For these analytical procedures, the Firm failed to establish appropriate expectations, as it compared weekly sales to the average weekly revenue for the year, without obtaining evidence as to why the average weekly revenue would be predictive of revenue for the individual weeks. In addition, the Firm used a threshold for investigation of differences that could have resulted in a combination of undetected misstatements that aggregated to an unacceptable amount. (AU 329, paragraphs .05, .13, .14, and .20)

    - Based on the Firm's overall scoping, which was not supported due to the deficiencies noted above, the Firm limited its procedures for the locations that it did not select to analytical procedures that it performed only with respect to amounts on the balance sheet. For inventory at those locations, the Firm compared certain current-year data to the corresponding data for the prior year. In these procedures, 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-year balance. In addition, the Firm used a threshold for investigation of unexpected differences for each location that was too high, as the threshold was the same as the Firm's amount of consolidated tolerable error. (AS No. 13, paragraph 8; AU 329, paragraphs .13, .14, and .20)

- o For revenue at the locations that the Firm did not select for testing, which, in the aggregate, was multiple times the Firm's established level of materiality and accounted for almost half of the issuer's revenue, the Firm failed to perform any substantive tests. (AS No. 13, paragraph 8)

A.6. Issuer F

In this audit of a manufacturer of medical devices, 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 entered into arrangements that had multiple elements; the issuer viewed training and installation for the main deliverable element to be perfunctory, and it therefore recognized revenue for these elements upon delivery of the main deliverable element, while deferring the recognition of revenue from other elements. The Firm identified fraud risks related to improper revenue recognition, including the possible recognition of revenue before significant obligations were provided. The Firm's testing related to the revenue from multiple-element arrangements was deficient in the following respects –

  - o The Firm failed to identify and test any controls that addressed the issuer's evaluation of (1) whether arrangements entered into separately with the same customer in close proximity were multiple-element arrangements for revenue recognition purposes; (2) the issuer's assertion that training and installation were perfunctory and therefore did not represent separate units of accounting; (3) whether vendor-specific objective evidence existed, and if not, whether third-party evidence existed; and (4) the issuer's best estimate of selling price. In addition, the Firm failed to perform any substantive procedures to address these issues. (AS No. 5, paragraph 39; AS No. 14, paragraph 30)

  - o The Firm selected for testing a control over the allowance for doubtful accounts that included the review of an accounts receivable aging report. The Firm, however, failed to identify and test any controls over the accuracy and completeness of this report.

In addition, for another control that involved the review of sales for appropriate revenue recognition, the issuer determined that relevant sales might not be reviewed through the operation of the control, but the Firm failed to perform procedures to determine the extent to which sales were not covered by the control and, if so, whether it was necessary to test controls that addressed the risk of material misstatement related to those sales. (AS No. 5, paragraph 39)

- o The Firm failed to test the accuracy and completeness, or to test controls over the accuracy and completeness, of a report that the Firm used in testing a control over credit and debit memoranda. (AS No. 15, paragraph 10)

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

  - o The Firm failed to sufficiently test a control that consisted of the calculation and review of the reserve for excess inventory. Specifically, the Firm's procedures were limited to inspecting documents for signatures that indicated the review performed as part of the control had occurred, comparing certain amounts to supporting documents or the general ledger, and inquiring of management. The Firm failed to test whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain, and evaluate, (1) the scope of the review activities performed, (2) the criteria used to identify items for follow up, and (3) how those items were resolved. In addition, the Firm identified a deficiency in controls over the accuracy and completeness of reports used in this control, and it identified two controls that it considered to compensate for the deficiency. These compensating controls consisted of the preparation of a monthly closing checklist and a quarterly review of the financial statements. The Firm failed to sufficiently test these compensating controls, as it did not perform any procedures to determine whether these controls operated at a level of precision that would detect potential material misstatements that could result from the deficiency in the control over the accuracy and completeness of the reports. (AS No. 5, paragraphs 42, 44, and 68)

- The Firm failed to identify and test any controls that addressed whether the types of labor and overhead costs that were included in inventory were appropriate. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of reports that the issuer used in the performance of certain controls that the Firm tested related to the valuation of inventory. (AS No. 5, paragraph 39)

- The issuer initially classified certain of its products that it used for demonstration purposes as inventory. If these products remained unsold after one year, the issuer reclassified them from inventory to equipment and depreciated these products over their remaining estimated useful life. The Firm failed to identify and test any controls over the determination of the estimated useful life of these demonstration products. In addition, the Firm failed to perform any substantive procedures to evaluate the reasonableness of the estimated useful life of these products. (AS No. 5, paragraph 39; AU 342, paragraph .10)

- For certain inventory owned by the issuer and held by sales representatives, the Firm selected for testing a control that consisted of obtaining confirmations from the sales representatives of inventory held. The Firm failed to sufficiently test this control, as its procedures were limited to gathering a sample of confirmations received from the sales representatives and reading these confirmations to identify whether there were any exceptions. These procedures did not include evaluating (1) whether the entire population of inventory held by sales representatives was subject to this control or (2) how exceptions the control owner identified on confirmations were resolved. In addition, when confirming this inventory with the sales representatives as part of its substantive procedures, the Firm identified exceptions related to this inventory, but failed to evaluate the effect of these exceptions on its conclusion regarding the operating effectiveness of this control. (AS No. 5, paragraphs 42, 44, and B8)

- o The Firm's testing to extend its conclusions on the existence of inventory from the date of its interim testing to the year end was insufficient. The Firm's roll-forward procedures consisted of (1) comparing the amounts on the issuer's roll-forward of the inventory balance by month for the fourth quarter to the same month in the previous year and (2) cut-off testing for a sample of transactions on the dates of the issuer's physical counts and at year end. For the sample of inventory transactions, the Firm, however, failed to (1) test the accuracy and completeness of the shipping and receiving logs from which it selected the sample and (2) determine whether the sampled items were recorded in the general ledger in the appropriate period. (AS No. 13, paragraph 45)

- o The Firm failed to sufficiently test the appropriateness of the capitalized labor and overhead inventory costs, as its procedures were limited to gathering certain production and overhead inventory schedules and comparing year-to-date totals to the general ledger. (AU 342, paragraph .10)

- o The Firm failed to sufficiently test the accuracy of certain reports that it used to test inventory reserves, as its testing of these reports was limited to comparing certain report totals to the subsidiary ledger and testing the reconciliation of the perpetual inventory to the general ledger. (AS No. 15, paragraph 10)

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 Firm failed to perform sufficient procedures related to net sales and accounts receivable at the domestic operations of two of the issuer's reportable segments; these operations represented almost half of the issuer's total net sales and accounts receivable. Specifically –

- o The Firm failed to sufficiently test certain of the controls over the processing and recording of sales and accounts receivable that it selected, as follows –

  - ▪ The Firm's testing of three of these controls, which included reviews or reconciliations, was limited to one or more of the following: inspecting emails and documents with signatures or other notations that indicated reviews and certain other actions performed as part of the controls had occurred, tracing information to the issuer's applications and/or supporting documents, and inquiring of the control owners. The Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to ascertain, and evaluate, the nature of the reviews performed, whether the control owners identified appropriate items for follow up, and whether those items were appropriately resolved. (AS No. 5, paragraphs 42 and 44)

  - ▪ The Firm's procedures to test two automated controls consisted of inspecting screen prints and invoices for a sample of transactions, without testing whether these controls were configured to operate over all relevant transactions.(AS No. 5, paragraph 42)

  - ▪ For three other automated controls, which operated within applications for which the Firm had concluded that the related ITGCs were ineffective, the Firm inappropriately limited its testing for each control to a sample of one item. (AS No. 5, paragraphs 46 and 47)

- o The Firm selected for testing controls over the allowance for doubtful accounts that consisted of (1) reviews of write-offs and past due balances and (2) an analysis of the allowance. The Firm's testing of these controls, however, was insufficient, as its procedures were limited to inspecting documents with signatures or other notations that indicated reviews and certain other actions performed as part of the controls had occurred; tracing information to the general ledger, reports, and/or supporting documents; testing the mathematical accuracy of certain calculations; and inquiring of the control owners. The Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to ascertain and evaluate (1) the nature of the reviews performed and (2) the criteria used by the control owners to identify matters for investigation and whether such matters were appropriately investigated and resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of reports used in the performance of certain of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm identified deficiencies in certain controls over revenue cut-off and access to important spreadsheets used in financial reporting. With respect to these control deficiencies, the Firm identified a compensating control that consisted of comparisons of actual results to budgeted amounts; however, the Firm's testing of this control was limited to inspecting evidence that reviews and certain other actions performed as part of the control had occurred, attending certain monthly meetings, and inquiring of the control owners. The Firm failed to evaluate whether the compensating control operated at a level of precision that would prevent or detect material misstatements, as the Firm failed to evaluate whether the control owners identified appropriate items for follow up and whether those items were appropriately resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of reports used in the performance of this control. (AS No. 5, paragraphs 39 and 68)

- The Firm's testing to extend its conclusion on the existence of accounts receivable for the six-month period between its interim testing and year end was insufficient. The Firm's roll-forward procedures were limited to (1) cut-off testing that was designed to provide little substantive assurance regarding the roll-forward period, (2) reading the issuer's analysis that rolled forward the monthly balances from the date of interim testing to the year end, and (3) comparing monthly accounts receivable balances to the balances for the prior month and/or the corresponding month in the prior year and evaluating certain differences only by applying the Firm's knowledge of the business. (AS No. 13, paragraph 45)

- The Firm identified a fraud risk related to an adjustment to the value of inventory that the issuer made to reflect the inventory at cost, but it failed to sufficiently test controls identified to address this risk. The Firm selected for testing controls that consisted of quarterly and annual reviews of the adjustment. The Firm's procedures to test these controls were limited to inspecting documents with signatures and other notations that indicated reviews and certain other actions performed as part of the controls had occurred, tracing information to the general ledger and/or supporting documents, testing the mathematical accuracy of certain calculations, and inquiring of the control owner. The Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate whether the control owners identified appropriate items for follow up and whether those items were appropriately resolved. (AS No. 5, paragraphs 42 and 44)

A.8. Issuer H

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

- For the issuer's main location, the Firm's procedures to test controls over inventory, cost of sales, and the period-end financial reporting process were insufficient. Specifically –
    - The issuer applied various costing methods to its different inventory types. The Firm failed to test certain important aspects of the control related to the costing method applied to one significant type of inventory, as its procedures were limited to testing the mathematical accuracy of the calculation and comparing the result to the general ledger. (AS No. 5, paragraphs 42 and 44)

- o The Firm selected for testing certain controls over inventory and cost of sales, as well as certain controls within the period-end financial reporting process, that consisted of reviews of various schedules, calculations, or reconciliations; however, the Firm failed to sufficiently test these controls. Specifically, the Firm's procedures were limited to one or more of the following: inquiring of issuer personnel; comparing certain data to supporting documentation or the general ledger; testing the mathematical accuracy of various calculations; and inspecting emails, meeting minutes, or documents with signatures or other notations that indicated reviews or approvals that constituted all or part of the controls had occurred. Although the Firm understood the nature of the review procedures that the control owners should have performed as part of the controls, the Firm failed to test whether those procedures were actually performed, including by testing the criteria used by the control owners to identify matters for investigation and whether specific items that were investigated were appropriately resolved. As a result, the Firm failed to test whether the controls operated at a level of precision that would prevent or detect material misstatements. In addition, the Firm used the work of IA as evidence of the effectiveness of another control over inventory; however, IA did not obtain evidence about certain important aspects of the control. (AS No. 5, paragraph 44)

- o The Firm failed to sufficiently evaluate the severity of certain deficiencies that it identified. The Firm concluded that controls over access to the issuer's IT application that processed inventory were ineffective and that the related deficiencies, in the aggregate, represented a significant deficiency. The Firm asserted that the deficiency did not constitute a material weakness as it was generally mitigated by multiple compensating controls that the Firm had tested (the testing of which is described above), but there was no evidence in the audit documentation that addressed how any of the other controls the Firm had tested compensated for this deficiency. The Firm specifically identified only one compensating control, which consisted of a one-time manual review of access logs by management. This control, however, did not mitigate the risks related to the deficiency, as the control was implemented after the issuer's year end and was used only to identify and correct errors made in transactions previously posted by those users whom the issuer had identified as having inappropriate access to the issuer's application. (AS No. 5, paragraph 68)

- For another of the issuer's locations selected for testing, the Firm's testing of controls for all of the significant accounts consisted of testing certain entity-level controls. These controls consisted of reviews of the location's annual operational plan and results, financial statement reporting packages, and weekly sales analyses. The Firm's procedures to test these controls were insufficient, as its testing was limited to gathering the analyses used in the performance of these controls. The Firm failed to evaluate whether the controls operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain the nature of the reviews performed, evaluate the criteria used by control owners to identify matters for investigation, and assess whether items identified were appropriately investigated and resolved. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of certain reports that the issuer used in the performance of these controls. (AS No. 5, paragraphs 39, 42, and 44)

- The issuer owned certain equipment that was installed and maintained at customer locations, and it recorded this equipment as part of its property, plant, and equipment when it was installed. The Firm failed to identify and test any controls that addressed the risk related to the existence of this equipment. In addition, the Firm failed to perform sufficient substantive procedures to test the existence of this equipment, as its procedures were limited to testing the original purchases and the disposals of this equipment during the year. (AS No. 5, paragraph 39; AS No. 13, paragraph 8)

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

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

- The Firm identified a fraud risk related to certain of the issuer's insurance reserves. The Firm selected for testing a control that included (1) a comparison between reserve estimates made by two different issuer actuaries, which included the analysis and resolution of significant variances ("peer-review analysis"), and (2) a comparison between prior-period reserve estimates and updated estimates based on subsequent actual claims, which included the analysis of significant variances ("hindsight analysis"). The Firm's procedures to test this control were insufficient. With respect to the peer-review analysis, the Firm limited its testing to inspecting the analysis and noting that there were no significant unresolved variances at the end of the review process; the Firm failed to sufficiently evaluate whether the design of this control was appropriate, as its evaluation did not address the critical aspect of the process during which significant judgments were reviewed and significant variances were resolved. With respect to the hindsight analysis, the Firm limited its testing to noting that significant variances were explained, without evaluating the reasonableness of the explanations. (AS No. 5, paragraphs 42 and 44)

- The Firm failed to perform sufficient procedures related to the valuation of goodwill and other intangible assets. Specifically –

    - The Firm selected for testing two controls over the issuer's budget and projected financial results; this information was used in the issuer's assessment of the possible impairment of goodwill and other intangible assets. The Firm, however, failed to sufficiently test these controls, as the Firm's procedures were limited to (1) noting that the budget was approved by the issuer's board of directors and (2) performing inquiries regarding the issuer's review of the projected financial results. For one of these controls, the Firm's testing did not address the nature of the review procedures performed, and, for the other control, the Firm's testing did not address the criteria used by the control owner to identify matters for investigation. As a result, 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 The Firm selected for testing a control that consisted of the reconciliation of certain assumptions used in the impairment analyses to system-generated reports. The Firm failed to identify and test any controls over the accuracy and completeness of these reports. (AS No. 5, paragraph 39)

- o The Firm used the reports noted above in its substantive testing of the valuation of other intangible assets, but it failed to perform procedures to test the accuracy and completeness of those reports. (AS No. 15, paragraph 10)

- The Firm failed to perform sufficient procedures to test revenue and accounts receivable. Specifically, the Firm failed to perform any procedures to test whether the criteria were met for recognizing the recorded revenue. In addition, in performing tests of details of accounts receivable, the Firm selected a sample only from subsidiary ledgers that exceeded a certain threshold, and therefore a significant portion of accounts receivable was not subject to testing. (AS No. 14, paragraph 30; AU 350, paragraph .24)

A.10. <u>Issuer J</u>

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

- For one of the issuer's two operating segments, the Firm identified a fraud risk related to revenue from contracts accounted for using the POC method, but failed to perform sufficient tests related to revenue from such contracts. Specifically –

- o The Firm selected for testing a control that consisted of monthly meetings at which the estimates to complete and POC calculations were reviewed. The Firm's procedures to test this control were limited to inspecting calendar invitations and documents with signatures that indicated reviews had occurred, comparing certain amounts to underlying data or the general ledger, and inquiring of one of the control owners. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain the specific nature of the reviews performed and to evaluate the criteria used by the control owners to identify matters for investigation. In addition, the Firm failed to identify and test any controls over the accuracy and completeness of a report used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- o The Firm assessed controls over this POC revenue as effective and performed substantive testing procedures that included (1) selecting the largest POC contracts for testing and (2) selecting the largest accounts receivable balances, as well as one additional accounts receivable balance, for testing. The amounts of POC revenue and accounts receivable that were not selected for this testing were multiple times the Firm's established level of materiality and represented approximately 55 percent of this revenue and 46 percent of this accounts receivable balance. The Firm failed to sufficiently test the remaining portions of revenue and accounts receivable, as (1) the Firm, when determining to use this testing approach, took into account its level of control reliance, which was not supported due to the deficiencies in the Firm's testing discussed above and (2) the Firm's only procedures with respect to the portions of revenue and accounts receivable not selected consisted of analytical procedures that provided little to no substantive assurance. Specifically, the expectations that the Firm used in the analytical procedures were only directional in nature, and the Firm's evaluation of the results of these procedures focused only on general explanations for the larger fluctuations that it identified. (AS No. 13, paragraphs 16, 18, and 37; AS No. 15, paragraph 27; AU 329, paragraphs .17 and .21)

- The Firm failed to perform sufficient procedures related to the issuer's inventory. Specifically –

  - o The Firm selected for testing a control that consisted of a quarterly review of the inventory reserves. The Firm's procedures to test this control were limited to inspecting documents with signatures or approvals that indicated the review had occurred and that the related journal entries had been recorded, tracing certain amounts to the general ledger and/or supporting documents, and inquiring of the control owner. The Firm failed to evaluate whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to (1) ascertain the specific nature of the reviews performed by the control owner and (2) evaluate whether the control owner identified appropriate items for follow up and whether those items were appropriately resolved. In addition, the Firm failed to sufficiently test the aspect of this control that it considered to address the accuracy of a report used in the performance of this control, as the Firm failed to identify that the control was not designed to address the accuracy of certain significant information in the report. Further, the Firm failed to identify and test any controls over the completeness of the report used in the performance of this control. (AS No. 5, paragraphs 39, 42, and 44)

- The Firm failed to identify and test any controls over the existence of the issuer's inventory that was held off-site by external vendors and manufacturers. (AS No. 5, paragraph 39)

- In performing its substantive procedures to test the completeness of certain inventory, the Firm made all of its selections for testing from a report derived from the issuer's system and failed to select any items for testing from the inventory on hand. (AS No. 13, paragraph 8)

- The Firm failed to test whether the indirect manufacturing costs that were included in inventory were appropriately capitalized, as its procedures were limited to (1) gathering supporting schedules and testing the mathematical accuracy of the overhead rates, (2) agreeing certain data to the issuer's system or to supporting documents, (3) verifying that the amounts to be applied based on these rates were correctly included in the inventory cost for certain products, and (4) comparing the current-year overhead rates to those from prior years and noting explanations for significant differences. (AU 342, paragraph .11)

- o The Firm failed to evaluate the reasonableness of certain assumptions and test the accuracy and completeness of certain data that the issuer used in determining its inventory reserves. (AU 342, paragraph .11)

A.11. Issuer K

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

- The Firm's procedures to test controls over the issuer's allowance for loan losses ("ALL") were insufficient. Specifically –

  - o The Firm identified a fraud risk related to the potential for management to manipulate the general reserve component of the ALL. The Firm selected for testing a control that it considered to be responsive to this risk; the control consisted of the review and approval of the ALL. The Firm failed to ascertain, and evaluate, how this control addressed the reasonableness of certain significant assumptions used in determining the general reserve component of the ALL. (AS No. 5, paragraphs 42 and 44)

  - o The Firm failed to identify and test any controls related to the approval of charge-offs of commercial and commercial real estate loans and the identification and approval of non-accrual loans. (AS No. 5, paragraph 39)

  - o The Firm determined that a control that consisted of the review of the risk rating for certain loans was ineffective. The Firm identified three controls that it believed mitigated this deficiency, but it failed to sufficiently test these compensating controls. Specifically, for two of the compensating controls, the Firm's procedures were limited to inquiring of issuer personnel and verifying, for a sample of loans, that ratings were assigned and approved or that changes in risk ratings had been approved, without evaluating the appropriateness of the ratings. The other compensating control that the Firm identified did not mitigate the risks related to the deficiency, as this control related only to the preparation and review of action plans for loans that had already been deemed to be substandard. (AS No. 5, paragraph 68)

- o There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested any controls over the accuracy and completeness of certain reports that the issuer used in the performance of certain of the controls that the Firm tested over the issuer's ALL. (AS No. 5, paragraph 39)

- o The Firm identified exceptions in its testing of a control that consisted of the review of the loan data entered in the issuer's system. The Firm's evaluation of the effect of these exceptions on its conclusion regarding the effectiveness of the control was limited to noting the exceptions were operational in nature, despite indications that the exceptions could have affected the financial statements. In addition, the Firm's procedures to update its testing of the control for the period between its interim testing and year end were limited to inquiry, which was insufficient given the exceptions noted during its interim testing. (AS No. 5, paragraphs 48, 55, and 56)

- The Firm failed to perform sufficient substantive procedures to test the general reserve component of the ALL, for which the Firm identified a fraud risk. Specifically, in developing the loss percentages that were applied to the various categories of loans to determine this component, the issuer judgmentally weighted certain of the historical loss rates; the Firm, however, failed to evaluate the reasonableness of this weighting. In addition, the issuer made certain qualitative adjustments to the historical loss factors when developing the loss percentages, but the Firm failed to test these qualitative adjustments. (AU 342, paragraph .11)

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 Firm failed to perform sufficient procedures related to revenue and accounts receivable for two of the issuer's segments, which represented most of the issuer's revenue and accounts receivable. Specifically –

  - With respect to the issuer's most significant type of revenue, the Firm selected for testing certain controls that addressed whether updated pricing information was successfully loaded weekly in the issuer's IT system. The Firm, however, failed to identify and test any controls over the accuracy of the pricing information in the issuer's IT system. (AS No. 5, paragraph 39)

  - The Firm identified certain deficiencies in controls related to the processing and recording of revenue, and it identified a compensating control that consisted of a monthly review of the results of the issuer's business lines. The Firm's procedures to test this control were limited to inquiring of management and gathering the issuer's summaries of the data reviewed, supporting schedules, and meeting invitations. The Firm failed to test whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate (1) the nature of the review activities performed, including whether the control owners used expectations to evaluate the results, (2) how those items identified for investigation were resolved, and (3) the reliability of the information used in the control. (AS No. 5, paragraph 68)

  - The Firm's strategy included testing controls over access to certain important applications, but it failed to perform sufficient testing of controls over access to certain IT applications that processed and recorded revenue transactions. Specifically, with respect to ITGCs related to user access for these IT applications, the Firm limited its procedures to testing access to a master application, based on an assumption that this application controlled access to these other applications. The Firm's procedures to evaluate the support for this assumption, however, were limited to inquiring of management and observing that one employee used the same password to access the master application and two of the other applications. In addition, the Firm failed to sufficiently test whether administrator-level access rights to the revenue applications were appropriately restricted, as the Firm evaluated the appropriateness of the administrator-level access rights for only the master application. (AS No. 5, paragraphs 42 and 44)

- The Firm tested certain application controls using a sample of one item; this approach was based on an assumption that ITGCs were effective, which was not supported due to the deficiencies in the testing of ITGCs that are described above. As a result, the Firm's testing of these application controls was insufficient. (AS No. 5, paragraphs 46 and 47)

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

- During the year, the issuer acquired two businesses. The issuer integrated certain locations for one of these businesses into its existing locations. The Firm failed to perform any substantive procedures to test revenue and accounts receivable for the remaining locations of this business and for the other acquired business. (AS No. 13, paragraph 36)

A.13. Issuer M

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

- The Firm failed to perform sufficient testing related to fixed-maturity investment securities. Specifically –

  - The Firm selected for testing a control that consisted of a review of variances in prices for these securities. An aspect of this control addressed the accuracy and completeness of the reports used in this control. The Firm limited its testing of this aspect of the control to inquiring of management; observing management create, from an underlying database, certain of the reports used in the review;

and testing the mathematical accuracy of certain formulae in a spreadsheet. The Firm, however, failed to ascertain, and evaluate the efficacy of, the specific actions performed by the control owner to determine the accuracy and completeness of the reports. (AS No. 5, paragraphs 42 and 44)

- o The Firm failed to identify and test any controls over the appropriateness of the issuer's method of accounting for the value of, and income from, its asset-backed fixed-maturity investment securities. (AS No. 5, paragraph 39)

- o The Firm's substantive testing of the value of, and income from, the asset-backed fixed-maturity investment securities was insufficient. In order for the issuer to apply the method of accounting that it used, the securities had to be of "high credit quality," as described in generally accepted accounting principles ("GAAP"), when acquired. The Firm's procedures to test whether the securities met this criterion were limited to inquiring of the issuer as to whether any securities had characteristics that would have required a different method of accounting. The Firm failed to evaluate the basis for the issuer's representation and failed to consider that certain of these investments had credit ratings below an AA rating when acquired, which would not have been indicative of high credit quality. (AS No. 14, paragraphs 3 and 30)

- The Firm failed to perform sufficient testing related to the valuation of certain insurance-related liabilities, consisting of reserves for future policy benefits. Specifically –

  - o The Firm's procedures to test the future policy benefits related to certain products, which were multiple times the Firm's established level of materiality and represented over half the reserve balance, were limited to reading certain fluctuation analyses that the issuer had prepared, reconciling the reserve balance for these products from the general ledger to the valuation application that the issuer used, and performing analytical procedures, which consisted of comparing reserve balances at the product level to the balances for the previous quarter and year. These analytical procedures provided little to no substantive assurance, as the Firm developed no expectations and failed to obtain corroboration of management's explanations for the differences between current- and prior-period amounts that exceeded its established threshold. (AU 329, paragraphs .05 and .21; AU 342, paragraph .10)

- o For the future policy benefits related to certain other products, which represented a substantial portion of the remaining reserve balance, the Firm's procedures consisted of a recalculation of the reserve for a sample of policies. In the recalculation, the Firm, however, used certain of the issuer's significant assumptions, without obtaining evidence to support its conclusion that the assumptions were reasonable. (AU 342, paragraph .11)

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 –

- During the year, the issuer contributed a line of business that was part of one of its operating segments to an entity in which the issuer retained an equity-method investment. The Firm failed to perform sufficient procedures to test two controls that it identified related to the accounting for this transaction; these controls consisted of a review of the valuation of the business and a review of the issuer's accounting memorandum for the transaction. The Firm's procedures to test these controls were limited to one or more of the following: inquiring of management, reading certain documents prepared by management, reading a report prepared by the issuer's specialist, attending meetings that constituted part of the operation of these controls, and gathering evidence that other meetings at which these reviews took place had been scheduled. The Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate the effectiveness of the specific steps that the control owners took to review the reasonableness of assumptions underlying the valuation and the accounting for the transaction. (AS No. 5, paragraphs 42 and 44)

- The Firm selected for testing two controls that consisted of the review of the issuer's goodwill impairment analysis, including the projected financial information used in that analysis, for one of the issuer's reporting units; 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, attending certain meetings that constituted part of the operation of one of these controls, testing the mathematical accuracy of certain calculations, and comparing certain amounts to supporting documentation. The Firm failed to evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements, as it failed to ascertain, and evaluate the effectiveness of, the specific steps that the control owners took to review the goodwill impairment analysis and the reasonableness of the underlying projected financial information. (AS No. 5, paragraphs 42 and 44)

- The Firm's substantive procedures to test the valuation of the business that the issuer deconsolidated and the goodwill for the reporting unit noted above were insufficient. Specifically, the issuer used certain significant assumptions, consisting of projections related to revenue, capital expenditures, and profit margins, in its analyses. The Firm's procedures to test these assumptions consisted of inquiry of management and a comparison of the assumptions to historical rates or industry data. These procedures were not sufficient to evaluate the reasonableness of these assumptions, as the Firm failed to consider the differences between certain of these assumptions and the issuer's historical rates or the industry data used for comparison. In addition, the Firm failed to evaluate whether the industry data that it used to evaluate the reasonableness of certain of these assumptions related to companies that were comparable to the issuer. (AS No. 14, paragraph 3; AU 328, paragraphs .26, .28, .31, and .36)

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

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements. Specifically, the Firm failed to identify that the issuer miscalculated the loss on the conversion of certain of its convertible notes. As a result, the Firm failed to evaluate whether the issuer's classification of the loss within its consolidated financial statements, as well as the incorrect disclosures related to the conversion, caused the financial statements to be materially misstated. (AS No. 14, paragraph 30)

A.16. Issuer P

In this audit of a real estate investment trust, 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 selected for testing a control that consisted of the issuer's review and approval of both the annual analysis of the potential impairment of real estate assets and the assessment of any required impairment charge.
    - The analysis reviewed as part of this control considered historical net operating losses as an impairment indicator. The Firm failed to test any controls that considered whether impairment indicators other than historical net operating losses were present. (AS No. 5, paragraph 39)
    - For one type of real estate asset for which historical net operating losses indicated a potential impairment, the Firm failed to sufficiently test the part of this control related to the assessment of whether an impairment should be recognized. Specifically, the Firm's procedures to test the aspect of the control consisting of the review and approval of significant assumptions used in this assessment were limited to inquiry, tests of the mathematical accuracy of calculations, and comparisons of certain assumptions to internal issuer documents or data. The Firm failed to test whether the control operated at a level of precision that would prevent or detect material misstatements, as it failed to evaluate (1) the nature of the review activities performed, (2) the criteria used to identify items for investigation, and (3) how those items identified for investigation were resolved. (AS No. 5, paragraphs 42 and 44)

- For one of the issuer's two operating segments, the Firm's substantive procedures to test the valuation of real estate assets were insufficient. The Firm limited its evaluation of impairment indicators to an assessment of historical net operating losses and failed to consider the possible existence of other indicators of impairment. In addition, in evaluating the recoverability of those assets, the Firm failed to consider disclosures by the issuer that it expected to dispose of that operating segment's real estate assets over the next several years. (AS No. 14, paragraph 3; AU 342, paragraph .11)

- For a significant type of real estate asset in the issuer's other operating segment, the Firm failed to sufficiently test certain significant assumptions used in the issuer's assessment of whether an impairment should be recognized, as the Firm's procedures were limited to inquiry, tests of the mathematical accuracy of certain calculations, and comparisons of certain data and assumptions to internal issuer documents or data that the Firm had not tested. (AU 328, paragraphs .26, .28, and .31)

A.17. Issuer Q

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, as the Firm failed to perform sufficient procedures related to raw materials inventory, which represented a significant portion of total inventory. Specifically –

- This inventory was subject to cycle counts, and the issuer used a system-generated report that specified which items to count each day. The Firm's procedures to test the existence of, and controls over the existence of, this inventory were insufficient. Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency. (AS No. 5, paragraph 39; AU 331, paragraph .11)

- The Firm's procedures to test the completeness of this inventory were also insufficient. The Firm's procedures were limited to selecting items for testing from the issuer's system-generated report, performing cut-off procedures at two dates, and inspecting certain inventory reconciliations. In light of the deficiency in testing the issuer's cycle-count process, these procedures did not provide sufficient evidence. (AU 331, paragraph .11)

A.18. Issuer R

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. Inventory for one component, which was multiple times the Firm's established level of materiality and represented approximately half of the issuer's total inventory, was subject to cycle counts, and the issuer used a system-generated report that specified which items to count each day. The Firm's procedures to test the existence of, and controls over the existence of, the issuer's inventory for this component were insufficient. Specifically, the Firm failed to test whether the cycle-count procedures that the issuer used provided reasonable assurance that sufficient inventory items were counted with sufficient frequency. (AS No. 5, paragraph 39; AU 331, paragraph .11)

A.19. Issuer S

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

- The issuer used distributors to sell its products, and it accounted for sales to these distributors as deferred revenue. The issuer recognized this revenue when the distributors sold the products to end users. The Firm identified a fraud risk related to the calculation of the deferred revenue and the potential for premature recognition of the related revenue. The control that the Firm selected for testing with respect to the deferral of revenue consisted of the preparation and review of reconciliations of distributor sales reports and related data to the general ledger; this control operated over both domestic and international revenue. Related to international revenue (which represented the majority of total revenue), the Firm failed to sufficiently test whether the control operated at a level of precision that would prevent or detect material misstatements. Specifically, while the Firm inquired regarding the review procedures performed with respect to the international revenue, it failed to evaluate the effectiveness of these review procedures, including by assessing whether the reviewer obtained sufficient information regarding the reconciliations, appropriately identified matters for follow up, and appropriately resolved those matters. (AS No. 5, paragraphs 42 and 44)

- In performing the control described above, the issuer used reports from the distributors showing their sales and inventory on hand. The Firm identified and tested three controls to address the accuracy and completeness of these reports; however, it did not obtain evidence that these controls sufficiently addressed the risks. Specifically, two of these controls did not address the inventory values reported by the distributors, as these controls consisted of (1) a comparison of inventory balances reported by the distributors to the inventory reported in the prior month in order to identify missing or stale reports and (2) a review of only the average selling prices within the distributor reports for a small number of the issuer's products. For the third control, which consisted of a comparison of reported sales data to forecasted data, the Firm failed to identify and test any controls over the accuracy and completeness of the forecasted data. (AS No. 5, paragraph 39)

A.20. Issuer T

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. During the year, the issuer acquired multiple businesses. Through its control and substantive testing, the Firm identified various misstatements related to the issuer's accounting for these business combinations, and the Firm concluded that the control over the issuer's accounting for business combinations that it had identified and tested was ineffective. The Firm identified and tested controls that it considered to compensate for this control deficiency and that consisted of management's monthly review of aggregated financial results and of management's and the audit committee's reviews of drafts of documents to be filed with the Securities and Exchange Commission ("SEC" or "the Commission"). The Firm failed to sufficiently evaluate whether these controls operated at a level of precision that would prevent or detect material misstatements, in that it failed to include in its evaluation that these controls had not detected the misstatements, one of which exceeded the Firm's established amount of tolerable misstatement. (AS No. 5, paragraph 68)

B. Auditing Standards

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

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

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

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

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

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited.

For each auditing standard, the table also provides the number of distinct deficiencies for which the standard is cited for each of the relevant issuer audits. This information identifies only the number of times that the standard is referenced, regardless of whether the reference includes multiple paragraphs or relates to multiple financial statement accounts.

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	Issuer A	5
	Issuer B	6
	Issuer C	7
	Issuer D	7
	Issuer E	5
	Issuer F	6
	Issuer G	6
	Issuer H	5
	Issuer I	3
	Issuer J	3
	Issuer K	5
	Issuer L	5
	Issuer M	2
	Issuer N	2
	Issuer P	2
	Issuer Q	1
	Issuer R	1
	Issuer S	2
	Issuer T	1
AS No. 9, *Audit Planning*	Issuer D	1
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer B	1
	Issuer C	5
	Issuer D	1
	Issuer E	2
	Issuer F	1
	Issuer G	1

PCAOB Auditing Standards	Audits	Number of Deficiencies per Audit
	Issuer H Issuer J Issuer L	1 2 1
AS No. 14, *Evaluating Audit Results*	Issuer C Issuer F Issuer I Issuer M Issuer N Issuer O Issuer P	2 1 1 1 1 1 1
AS No. 15, *Audit Evidence*	Issuer A Issuer B Issuer C Issuer F Issuer I Issuer J	1 1 2 2 1 1
AU 328, *Auditing Fair Value Measurements and Disclosures*	Issuer N Issuer P	1 1
AU 329, *Substantive Analytical Procedures*	Issuer E Issuer J Issuer M	2 1 1
AU 331, *Inventories*	Issuer C Issuer D Issuer Q Issuer R	1 1 2 1
AU 342, *Auditing Accounting Estimates*	Issuer A Issuer C Issuer F	3 3 2

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
	Issuer J Issuer K Issuer M Issuer P	2 1 2 1
AU 350, *Audit Sampling*	Issuer B Issuer C Issuer D Issuer I	1 1 2 1

B.2. Financial Statement Accounts or Auditing Areas Related to Identified Audit Deficiencies

The table below lists the financial statement accounts or auditing areas related to each deficiency included in Part I.A of this report and identifies the audits described in Part I.A where deficiencies relating to the respective areas were observed.[4]

	AS No. 5	AS No. 9	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 342	AU 350
Business combination, including contingent consideration	T									
Convertible debt, including gain/loss on conversion				O						
Impairment of goodwill and intangible assets	I, N			N	I	N				
Insurance reserves	I						M		M	

[4] Certain deficiencies that affect multiple accounts or areas, such as those related to scoping multi-location audits and those related to the evaluation of control deficiencies, are excluded from this table, but are included in Appendix D.

	AS No. 5	AS No. 9	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 342	AU 350
Inventory and related reserves	C, D, E, F, G, H, J, Q, R, S	D	D, E, F, J	C	C, F		E	C, D, Q, R	C, F, J	D
Investment securities and equity-method investments	M, N			M, N		N				
IT-related	A, E									
Loans, including ALL	K								K	
Long-lived assets, including amortization, depreciation or depletion	A, B, H, P		B, H	P	A, B	P			A, P	B
Period-end financial reporting process	A, D, H									
Revenue, including accounts receivable, deferred revenue, and allowances	B, C, D, E, F, G, H, J, L, S	D	B, C, D, E, G, J, L	C, F, I	C, F, J		E, J		C	B, C, D, I

B.3. Audit Deficiencies by Industry

The table below lists the industries[5] of the issuers for which audit deficiencies were discussed in Part I.A of this report, along with the specific auditing standards related to the deficiencies and the number of issuer audits where those deficiencies were observed.[6] Because an issuer audit may have deficiencies that relate to more than one standard, the total for each row should not be read as a total number of issuers.

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[5] The majority of industry sector data is based on Global Industry Classification Standard ("GICS") data obtained from Standard & Poor's ("S&P"). In instances where GICS for an issuer is not available from S&P, classifications are assigned based upon North American Industry Classification System data.

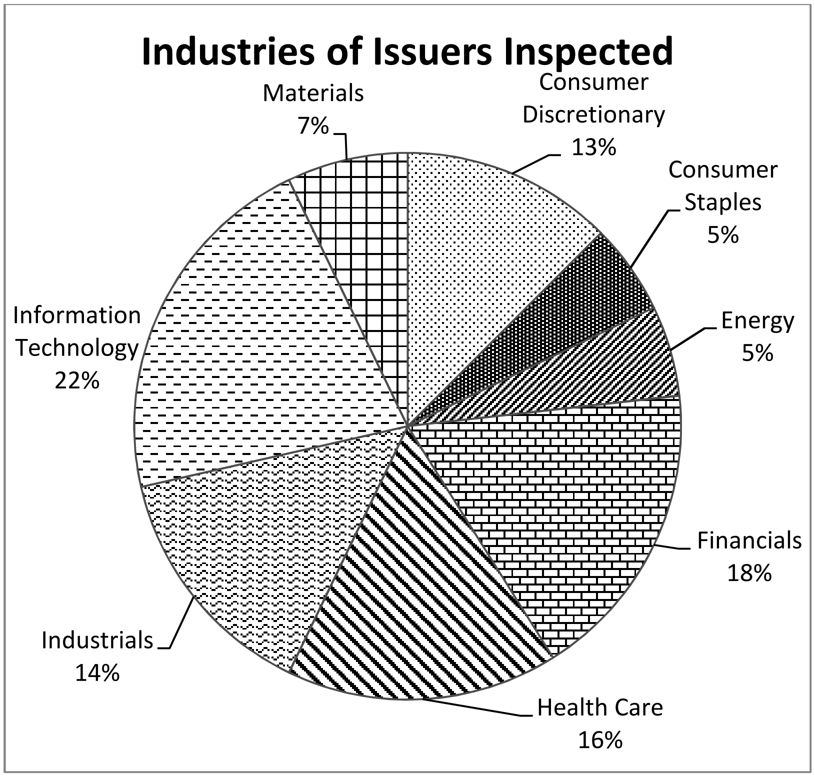
[6] Where identifying the industry of the issuer may enhance the understanding of the description of a deficiency in Part I.A, industry information is also provided there, unless doing so would have the effect of making the issuer identifiable.

	AS No. 5	AS No. 9	AS No. 13	AS No. 14	AS No. 15	AU 328	AU 329	AU 331	AU 342	AU 350
Consumer Discretionary	1		1				1			
Consumer Staples	1		1							
Energy	1				1				1	
Financial	5		1	2	1	1	1		3	1
Healthcare	4		3	3	2				1	1
Industrials	3		2	2	2	1	1	1	2	1
Information Technology	2							1		
Materials	2	1	1					2		1

C. Data Related to the Issuer Audits Selected for Inspection

C.1. Industries of Issuers Inspected

The chart below categorizes the 56 issuers whose audits were inspected in 2014, based on the issuer's industry.[7]

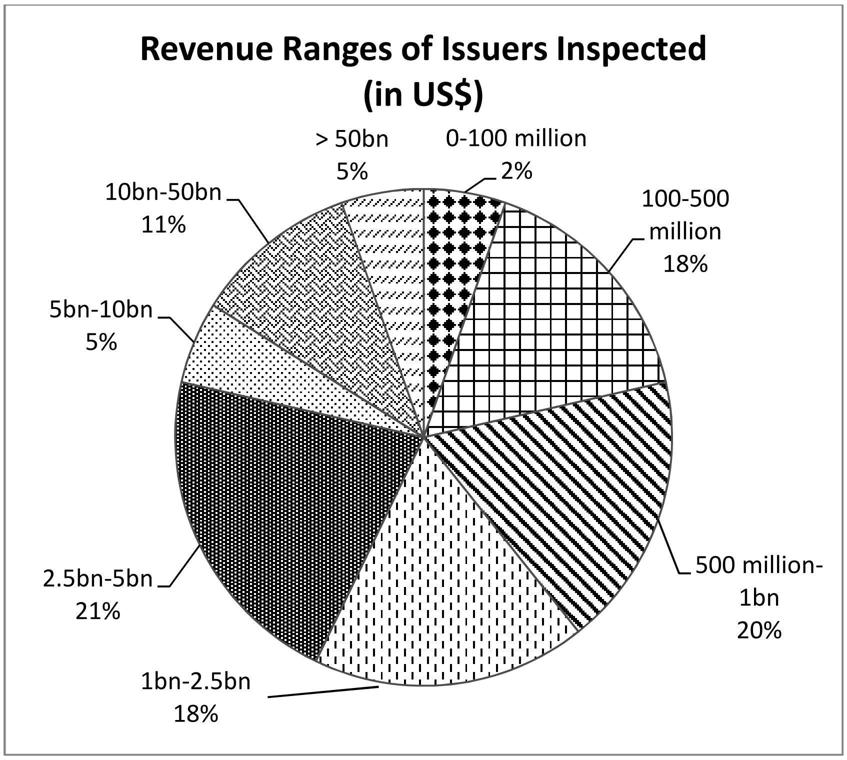


Industry	Number of Audits Inspected	Percentage
Consumer Discretionary	7	13%
Consumer Staples	3	5%
Energy	3	5%
Financials	10	18%
Health Care	9	16%
Industrials	8	14%
Information Technology	12	22%
Materials	4	7%

[7] See Footnote 5 for additional information on how industry sectors were classified.

C.2. Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 56 issuers whose audits were inspected in 2014.[8] This presentation of revenue data is intended to provide information about the size of issuer audits that were inspected and is not indicative of whether the inspection included a review of the Firm's auditing of revenue in the issuer audits selected for review.



Revenue (in US$)	Number of Audits Inspected	Percentage
0-100 million	1	2%
100 million-500 million	10	18%
500 million -1bn	11	20%
1bn-2.5bn	10	18%
2.5bn-5bn	12	21%
5bn-10bn	3	5%
10bn-50bn	6	11%
>50bn	3	5%

8 The revenue amounts reflected in the chart are for the issuer's fiscal year end that corresponds to the audit inspected by the PCAOB. The revenue amounts were obtained from S&P and reflect a standardized approach to presenting revenue amounts.

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

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

D.1. Reviews of Audit Work

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

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[9] as well as a firm's failures to perform, or to perform sufficiently, certain necessary audit procedures. An inspection of an annually inspected firm does not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

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

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[9] When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with the applicable financial reporting framework, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[10]

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

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

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

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

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

assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion or a failure to obtain sufficient appropriate audit evidence to fulfill the objectives of the firm's role in an audit may indicate a defect or potential defect in a firm's quality control system.[11] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[12] related firm methodology, guidance, and practices; and possible root causes.

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

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

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

foreign affiliates perform on the foreign operations of the firm's U.S. issuer audits; and (5) the firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to defects or potential defects in quality control. A description of the procedures generally applied to these areas is below.

D.2.a. <u>Review of Management Structure and Processes, Including the Tone at the Top</u>

Procedures in this area are designed to focus on (1) how management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance and (2) whether actions and communications by the firm's leadership – the tone at the top – demonstrate a commitment to audit quality. To assess this area, the inspection team may interview members of the firm's leadership and review significant management reports and documents, as well as information regarding financial metrics and other processes that the firm uses to plan and evaluate its business.

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

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

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

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

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

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

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

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

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

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

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

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

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

END OF PART I

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

APPENDIX C

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[13]

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

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

June 8, 2015

Response to Part I of the Draft Report on the 2014 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 2014 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.
Managing Partner

Francis C. Mahoney
Vice Chair Assurance Services

APPENDIX D

AUDITING STANDARDS REFERENCED IN PART I

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

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
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 E

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
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, P, Q, R, and S
TESTING CONTROLS		
Testing Design Effectiveness		
AS No. 5.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. 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, J, K, L, M, N, P, and S
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	Issuers A, B, C, D, E, F, G, H, I, J, K, L, M, N, P, and S

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	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.	
Relationship of Risk to the Evidence to be Obtained		
AS No. 5.46	For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.	Issuers G and L
AS No. 5.47	Factors that affect the risk associated with a control include – • The nature and materiality of misstatements that the control is intended to prevent or detect; • The inherent risk associated with the related account(s) and assertion(s); • Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness; • Whether the account has a history of errors;	Issuers G and L

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	• The effectiveness of entity-level controls, especially controls that monitor other controls; • The nature of the control and the frequency with which it operates; • The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls); • The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance; • Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls. • The complexity of the control and the significance of the judgments that must be made in connection with its operation. Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.	

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
AS No. 5.48	When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.	Issuers E and K
AS No. 5.55	*Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.	Issuers D and K
AS No. 5.56	The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors – • The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests; • The sufficiency of the evidence of effectiveness obtained at an interim date; • The length of the remaining period; and • The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date. Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be	Issuers D and K

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
	sufficient as a roll-forward procedure.	
EVALUATING IDENTIFIED DEFICIENCIES		
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 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.	Issuer E

AS No. 5, ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***		
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, F, G, H, K, L, and T
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 F
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.	Issuer A

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*		
MULTIPLE LOCATIONS SCOPING DECISIONS		
AS No. 5.B10	In determining the locations or business units at 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.	Issuers D and E

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 D
<u>Footnote to AS No. 9.11</u>		

AS No. 9, *Audit Planning*		
[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 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	Issuer D

AS No. 9, *Audit Planning*

	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. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Responses Involving the Nature, Timing, and Extent of Audit Procedures		
AS No. 13.8	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers C, E, H, and J
RESPONSES TO FRAUD RISKS		
AS No. 13.13	*Addressing Fraud Risks in the Audit of Financial Statements*. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.	Issuer C

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
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 B, D, and J
Footnotes to AS No. 13.16 [12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures. [13/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.		
AS No. 13.18	*Evidence about the Effectiveness of Controls in the Audit of Financial Statements*. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.	Issuers B, D, and J
Substantive Procedures		
AS No. 13.36	The auditor should perform substantive procedures for each relevant assertion of each significant	Issuer L

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
	account and disclosure, regardless of the assessed level of control risk.	
AS No. 13.37	As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.	Issuers B, C, D, and J
TIMING OF SUBSTANTIVE PROCEDURES		
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 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.	Issuers F and G

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 M, N, and P

AS No. 14, *Evaluating Audit Results*		
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 SEC for the company under audit with respect to the accounting principles applicable to that company.	Issuers C, F, I, M, and O

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 B, C, F, and I

AS No. 15, *Audit Evidence*		
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		
SELECTING SPECIFIC ITEMS		
AS No. 15.27	The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[12/]	Issuers A, C, and J
Footnote to AS No. 15.27 [12/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.		

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AU 328.26	The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market	Issuers N and P

AU 328, *Auditing Fair Value Measurements and Disclosures*		
	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.	
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 N and P
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 N and P
AU 328.36	To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),[fn 5] individually and taken as a whole, need to be realistic and consistent with: a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances; b. Existing market information; c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies; d. Assumptions made in prior periods, if appropriate; e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable; f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and g. The risk associated with cash flows, if applicable, including the potential variability in the amount and	Issuer N

AU 328, *Auditing Fair Value Measurements and Disclosures*		
	timing of the cash flows and the related effect on the discount rate. Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.	
Footnote to AU 328.36 fn 5 The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).		

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

AU 329, *Substantive Analytical Procedures*		
Analytical Procedures Used as Substantive Tests		
Plausibility and Predictability of the Relationship		
AU 329.13	It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.	Issuer E
AU 329.14	As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.	Issuer E
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 .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.	Issuer J

AU 329, *Substantive Analytical Procedures*		
Investigation and Evaluation of Significant Differences		
AU 329.20	In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.	Issuer E
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 J and M

AU 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	Issuers C, D, Q, and R

AU 331, *Inventories*		
	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.]	

AU 342, *Auditing Accounting Estimates*		
Evaluating Accounting Estimates		
Evaluating Reasonableness		
AU 342.10	In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches: a. Review and test the process used by management to develop the estimate. b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate. c. Review subsequent events or transactions occurring prior to the date of the auditor's report. Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.	Issuers F and M
AU 342.11	Review and test management's process. In many	Issuers A, C,

AU 342, *Auditing Accounting Estimates*		
	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: d. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. e. 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. f. Consider whether there are additional key factors or alternative assumptions about the factors. g. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. h. 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. i. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions. j. 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. k. Consider using the work of a specialist regarding certain assumptions (section 336, Using the Work of a Specialist). l. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.	J, K, M, and P

AU 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 C
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 B and D
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		

AU 350, *Audit Sampling*		
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 B and D
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 B and D
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 I
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.		
Sampling In Tests Of		

AU 350, *Audit Sampling*		
Controls		
Planning Samples		
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 D