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Report on

2012 Inspection of KPMG 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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Preface

In 2012, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm KPMG LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").[1/]

The inspection process is designed, and inspections are performed, to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. The inspection process included reviews of aspects of selected issuer audits completed by the Firm. The reviews were intended to identify whether deficiencies existed in those aspects of the audits, and whether such deficiencies indicated defects in the Firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The issuer audits and aspects of those audits inspected were selected based on a number of risk-related and other factors. Due to the selection process, the deficiencies included in this report are not necessarily representative of the Firm's issuer audit practice.

The Board is issuing this report in accordance with the requirements of the Act.[2/] The Board is releasing to the public Part I of the report and portions of Appendix C. Appendix C includes the Firm's comments, if any, on a draft of the report. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

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

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

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures for the inspection from October 2011 through February 2013. The inspection team performed field work at the Firm's National Office and at 28 of its approximately 83 U.S. practice offices.

A. Review of Audit Engagements

The 2012 inspection of the Firm included reviews of aspects of 48 audits performed by the Firm and reviews of the Firm's audit work on two other issuer audit engagements in which the Firm played a role but was not the principal auditor. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. One of the deficiencies relates to auditing aspects of an issuer's financial statements that the issuer announced an intention to restate after the primary inspection procedures.

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR"). In addition, in two audits in which the Firm played a role but was not the principal auditor, the inspection team identified deficiencies that were of such significance that it appeared that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audit. The audit deficiencies that reached these levels of significance are described below.[3/]

[3/] 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.

For one of the audits described below, following the inspection team's primary inspection procedures, the Firm revised its opinion on the effectiveness of the issuer's ICFR to express an adverse opinion.

A.1. Issuer A

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

- The Firm identified numerous control deficiencies, including deficiencies related to identified misstatements that exceeded the Firm's established level of materiality. The Firm failed to sufficiently evaluate whether certain of these control deficiencies represented material weaknesses individually, as it failed to evaluate the likelihood and magnitude of the potential misstatements that could result from the deficiencies. In addition, the Firm failed to evaluate whether some of these control deficiencies, when considered in combination, collectively resulted in a material weakness.

- The Firm identified a fraud risk related to revenue recognition, including a risk with respect to the issuer's largest customer, which represented a significant portion of both total accounts receivable and total revenue. The Firm failed to perform sufficient procedures to test revenue and related accounts receivable, including procedures that were directly responsive to the assessed risk of fraud related to revenue from the issuer's largest customer.

  - The Firm's primary procedure to test revenue was to develop an independent expectation of total revenue for the year based on cash receipts for the year and changes in the balances for accounts receivable, relevant reserves, and deferred revenue from the beginning to the end of the year. The Firm failed to develop an appropriate expectation since, as noted below, the Firm failed to sufficiently test accounts receivable that it used in developing the expectation. While the Firm did perform other testing of a sample of individual revenue transactions, the sample size for this testing was too small, because the Firm placed unwarranted reliance on its primary procedure.

- As part of its testing of accounts receivable, the Firm sent confirmation requests for a sample of invoices that related to sales to this customer's U.S. entity; each invoice contained billings pursuant to many purchase orders. The customer confirmation requests also included questions as to whether there were any contract modifications and/or side agreements. None of these confirmation requests was returned. The Firm's alternative procedures, which focused on the recorded accounts receivable amounts, were insufficient.

  - In performing its alternative procedures, the Firm compared certain of the selected invoices to a report that the issuer had prepared for that particular invoice that listed the sales included in the invoice by purchase order. The Firm's testing of the accuracy and completeness of the data in these reports was insufficient, because it tested the data in only one of these reports, and it had not tested controls over the compilation of the data in the reports.

  - For each of the selected invoices, the Firm tested only the first three of the many purchase orders included in the invoice. The Firm obtained shipping documents related to these purchase orders; however, these shipping documents did not include quantities or the value of items shipped, and the Firm did not perform other procedures to determine the accuracy of the amounts in the invoices.

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 –

- During the year, the issuer sold certain operations and abandoned the remaining operations of one of its reporting segments that operated in an emerging market. Although the issuer had reported certain negative information about this reporting segment, it had also made positive statements about the segment's prospects and made significant capital expenditures related to the segment during the year. The segment had significant net assets as of the date of disposal. The purchaser was an entity that had no other assets or operations, and the consideration the issuer received was a small percentage ownership interest in the purchaser.

  The Firm's procedures to test this transaction were insufficient. Specifically, the Firm's procedures were limited to reviewing the purchase agreement, performing analytical procedures regarding the operations of the segment for the portion of the year that the business was owned by the issuer, testing the mathematical accuracy of the calculation of loss from discontinued operations, and evaluating the disclosure and classification of the discontinued operations. The Firm failed to determine and assess the business rationale for the structure of the transaction. Further, the Firm failed to evaluate whether the issuer should have disclosed the fact that the purchaser had no other operations.

- The Firm failed to sufficiently evaluate the severity of identified control deficiencies when concluding that these deficiencies, individually and in combination, were not material weaknesses. Specifically, the Firm's conclusions were based upon its evaluation that two compensating controls mitigated the deficiencies. The Firm, however, failed to test whether one of these controls operated at a level of precision that would prevent or detect a misstatement that could be material, and its evaluation of the controls did not take into account that (a) the other control had failed to detect misstatements that were in excess of the Firm's established level of materiality, and (b) these compensating controls could be subject to management override because of the control deficiencies the Firm had identified. Finally, in evaluating the severity of one of the control deficiencies, the Firm considered only the magnitude of the misstatements that it knew had not been detected through the operation of the control, rather than the potential misstatements that could result from the deficiency.

- The Firm failed to perform sufficient substantive procedures to test revenue. Specifically, despite identifying a deficiency in the issuer's control over manual journal entries, which the issuer used to record certain revenue, and identifying a risk of fraud related to inappropriate revenue recognition, the Firm selected only a small number of journal entries for testing, none of which related to the issuer's most significant type of revenue. In addition, the Firm's sample of revenue transactions was insufficient, as the Firm determined its sample size based on the requirements for control testing rather than those for substantive testing, which required a larger sample. The Firm also tested revenue by testing the issuer's analysis of revenue, which involved forming an expectation based on the amount of cash received related to revenue during the period, taking into account the change in the recorded accounts receivable. The Firm's testing of the issuer's calculation of the revenue-related cash receipts was insufficient, as it failed to test the completeness of the deductions from the cash receipts for non-revenue-related items. In addition, the Firm failed to evaluate the significant difference between the expected revenue and the revenue recorded by the issuer.

- With respect to the valuation of assets acquired in business combinations, for which the Firm had identified a significant risk, the Firm failed to perform sufficient tests of controls and substantive procedures. Specifically –

    - The Firm identified and tested one control over the accounting for business combinations, but the Firm's testing of that control was limited to inquiring of management and noting that certain changes were made as a result of the review that constituted a part of the control, without determining whether the control operated at a level of precision that would prevent or detect a material misstatement. In addition, the Firm failed to identify and test any controls over the issuer's accumulation of the data underlying the assumptions that were used to value certain acquired intangible assets.

    - The Firm failed to sufficiently test the attrition rates the issuer used to value customer-relationship intangible assets, as its testing was limited to inquiring of management and performing a sensitivity analysis for a subset of the acquisitions. This sensitivity analysis, in which the Firm used the lower attrition rate that the issuer had used to value similar assets in other acquisitions, showed a calculated amount that was significantly larger than the recorded value of the assets, but the Firm performed no additional procedures to evaluate the results of this analysis

- o The Firm's evaluation of the reasonableness of the issuer's assumed growth rate for revenue from existing customers, which was used in valuing the customer-relationship intangible assets for one of these acquisitions, was insufficient. Specifically, the Firm's procedures were limited to comparing that rate to the rate of inflation, without taking into account higher actual and projected total revenue growth rates.

- o The Firm failed to sufficiently test the value of certain acquired property, plant, and equipment, as it relied on information provided by the issuer without testing this information.

A.3. Issuer C

For a new audit client, the Firm determined the scope of its procedures for the audits of the financial statements and the effectiveness of ICFR based on a materiality level that was too high under the circumstances and, as a result, it failed to obtain sufficient appropriate audit evidence to support its audit opinions. The issuer had a history of revenue and earnings from an ongoing, mature business (including during the year under audit) and had emphasized revenue and earnings in its communications with investors. The Firm, however, determined a materiality level based on a percentage of the issuer's total assets, without establishing that it had an appropriate basis for doing so. This materiality level was approximately three times the materiality level the Firm would have calculated had it used its guidance for the typical approach to determining a materiality level based on income before taxes for the year.

A.4. Issuer D

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

- The Firm assessed the risk of material misstatement of the allowance for loan losses ("ALL") as high and also identified a fraud risk related to the ALL. The Firm selected and tested six review controls over the issuer's loan grading and ALL evaluation process. The Firm's testing of these controls was insufficient. Specifically –

  - In its testing of four of the review controls, the Firm failed to evaluate the criteria the control owner used to identify exceptions, and failed to test whether exceptions had been appropriately identified and investigated. The Firm also failed to test one of these four controls, which involved management's review of the ALL model methodology, in the third and fourth quarters of the year, despite the fact that the issuer significantly revised its methodology in the third quarter. Further, the Firm failed to test controls over the accuracy and completeness of certain reports used in the performance of another of these four controls.

  - The Firm failed to evaluate the effects of exceptions related to loan grading that it identified when performing loan reviews, on its conclusion regarding the operating effectiveness of the fifth control, which was designed to identify errors in loan grading.

  - The Firm's procedures to test the sixth control were limited to comparing its independent conclusions to those reached by the control owner, without evaluating the procedures performed by the control owner.

- Historically, the issuer had determined its general reserve by selecting, for each loan type, the largest of the reserves calculated by three separate models (the "Traditional Method"). Beginning in the third quarter of the year, the issuer calculated an estimate of the general reserve using a new method based on credit risk (the "Credit Risk Method"), and it used the results from both methods, along with an amount representing a qualitative adjustment, to determine the general reserve. The Firm concluded that it would not rely on the Credit Risk Method, and did not substantively test it. The Firm's approach for testing the general reserve portion of the ALL was to evaluate the issuer's process for estimating the general reserve using the Traditional Method and to develop an independent expectation of the general reserve. The Firm's testing was insufficient. Specifically –

- The Firm developed its independent expectation of the general reserve for each loan type by applying the ratio of charge-offs during the year as compared to the prior year's ending loan balances to the current year's loan balances. The Firm, however, failed to support its use of one year of charge-off data, and its exclusion of any qualitative or environmental factors.

- The Firm failed to evaluate the appropriateness of the issuer's qualitative adjustments.

- In reviewing the Traditional Method, the Firm failed to evaluate the issuer's decision to use the largest calculated reserve for each loan type, despite significant differences in the amounts produced by the three different models underlying the Traditional Method.

- The Firm identified two design deficiencies in the model that produced the largest calculated reserve for most of the issuer's loan types, and thus was used to determine substantially all of the reserve under the Traditional Method. This model applied loss rates to various categories of loan grades. The design deficiencies that the Firm identified related to the fact that the loss rates were unchanged from period to period and the grouping of loan grades was too aggregated. In response to these deficiencies, the Firm calculated various ratios related to loans, charge-offs, and the ALL, and compared the results to those for peer institutions; however, this analysis was not precise enough to address the specific design deficiencies. In addition, the Firm failed to test the reasonableness of the loss rates that the issuer applied in this model.

- The Firm's procedures to test the specific reserve portion of the ALL were insufficient. The Firm failed to evaluate the reasonableness of significant assumptions used in appraising the fair value of the collateral for nearly all of the loans that it had selected for testing, and failed to evaluate the reasonableness of discounts that the issuer had applied to the appraised values.

- The Firm's procedures to test the loan grades of a sample of loans were insufficient. The Firm's specialist identified a number of loan grading differences in the sample, nearly all of which related to a portfolio of commercial loans. Although the Firm extrapolated the error rate for this portfolio to the rest of the population of the portfolio, it did not have a basis to do so since it did not test a representative sample of loans. In addition, the Firm failed to consider the nature of the loan grading differences and the specific characteristics of this portfolio to evaluate whether further procedures to test the portfolio were necessary.

- The Firm's procedures to test the effectiveness of controls over the issuer's investment securities were insufficient. Specifically, the Firm identified and tested three review controls related to valuation. The Firm failed to assess the level of precision at which each of the controls operated. In addition, the Firm failed to test whether the issuer's controls addressed the need for the issuer to have a sufficient understanding of how the external pricing vendors had priced certain of the issuer's investment securities without readily determinable fair values to enable the issuer to determine (a) whether the prices were reasonable and determined in accordance with generally accepted accounting principles ("GAAP"), and (b) whether the securities were appropriately classified within the fair value hierarchy.

- The Firm failed to perform sufficient substantive tests of the issuer's investment securities. Specifically —

    - The Firm's testing of the fair value of certain municipal securities within the issuer's investment securities portfolio was insufficient. The Firm's internal valuation specialists developed independent expectations of the fair values of these securities; these expectations, however, depended on a significant assumption that was not supported by audit evidence other than the results of inquiry of management.

    - The Firm tested the value of the issuer's investment securities as of the end of the third quarter. The Firm developed expectations of the year-end values and tested purchases of securities after the interim testing date in order to extend its conclusions to the year end. These procedures, however, were not sufficient, because (a) the Firm's expectations of the year-end values were formed using benchmarks related to the various groups of securities that the issuer owned, without consideration of whether the specific securities within those groups corresponded to those contributing to the benchmarks, and (b) the Firm's testing of purchases since the interim testing date consisted of verifying the prices at the date of purchase, without any procedures to test the prices at year end.

- The Firm failed to perform sufficient substantive procedures to test the issuer's valuation of real estate it owned, for which the Firm had identified a risk of fraud. Specifically, the Firm evaluated the reasonableness of the assumptions used in the valuation of only a small portion -- less than ten percent -- of the real estate properties that it had selected for substantive testing.

A.5. Issuer E

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The issuer modified its ALL processes during the year, and determined that the fact that the required revisions to its controls had not been fully implemented as of year end represented a significant deficiency. The issuer also identified other control deficiencies related to its ALL processes. In addition, the issuer and the Firm identified multiple deficiencies in information-technology general controls ("ITGCs") that affected user access to various applications supporting the ALL. The issuer determined, and the Firm agreed, that these deficiencies in controls over the ALL and related ITGCs did not constitute a material weakness. The Firm, however, failed to sufficiently evaluate the severity of these control deficiencies when making that determination. Specifically –

- The Firm identified actual and potential misstatements in the issuer's ALL that, when aggregated, exceeded the Firm's revised materiality level. The Firm failed to consider the full range of the potential misstatements in concluding that the ALL control deficiencies were not a material weakness.

- The Firm identified four compensating controls that it believed mitigated the ALL deficiencies. The Firm, however, failed to obtain evidence that these compensating controls operated at a level of precision such that the controls would have the necessary mitigating effect.

- The Firm failed to evaluate the deficiencies identified in controls over the ALL in combination with the multiple user-access deficiencies related to applications supporting the ALL.

A.6. Issuer F

In connection with a foreign affiliated firm's audit of an issuer, the Firm audited certain financial statement information of a subsidiary of the issuer and tested the subsidiary's controls. The operations of this subsidiary consisted of a legacy business and a business acquired during the year. The Firm failed in the following respects to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit –

- The Firm failed to test the design and operating effectiveness of controls over the accounting for business combinations.

- The Firm failed to identify and test any controls over the existence of available-for-sale ("AFS") securities of the acquired business.

- The issuer classifies loans as impaired primarily based on each loan's risk rating. The Firm selected for testing certain controls over specific reserves for impaired loans, including controls over loan risk ratings, but its procedures to test these controls were insufficient. Specifically, the issuer used manually prepared information in the operation of these controls; the Firm, however, failed to test any controls over the accuracy and completeness of this information. In addition, the sample sizes that the Firm used to test the operating effectiveness of the issuer's controls over loan risk ratings were too small. Specifically, the samples were based on a low risk associated with the controls, despite the assessed high inherent risk related to the ALL, deficiencies that had been identified in the loan risk rating process, and an identified fraud risk.

- The Firm failed to perform sufficient substantive procedures to test the assets acquired and liabilities assumed in the business combination. Specifically –

  - The Firm's sample size for testing the risk ratings assigned to the acquired loans, which was a significant input into the valuation of these loans, was insufficient. Specifically, the Firm determined its sample size based on a risk of material misstatement of low, but failed to consider multiple factors that it had identified that indicated a higher risk, such as an identified fraud risk, weaknesses identified by the issuer's risk group with respect to certain assumptions used in the model to value the loans, and identified control deficiencies.

  - The Firm's approach to testing assumed deposit liabilities was to perform procedures subsequent to the acquisition date and roll back its conclusions from the date of testing to the acquisition date. The Firm's roll-back procedures, however, were insufficient, since the procedures were limited to a comparison of the balances at those dates.

  - The Firm selected a sample of investment securities acquired in the business combination to test existence; however, the population the Firm tested excluded a significant portion of the acquired investment securities.

A.7. <u>Issuer G</u>

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

- The Firm's testing of certain controls over revenue, for which the Firm had identified a fraud risk, and over accounts receivable was insufficient. Specifically –

  - The Firm selected a control over invoices that operated only on transactions above certain quantitative thresholds. While some portion of the transactions that were not subject to this control were addressed by other controls, such as those related to the timing of revenue recognition, the Firm failed to consider the population of transactions that was not subject to this control when determining that the controls it identified and tested sufficiently addressed the assessed risk of misstatement.

- o For two review controls that the Firm selected for testing, the Firm failed to test whether the persons who performed the control appropriately identified and investigated variances that met the controls' established criteria for investigation.

- o In addition, for two of the three controls described above, and one other control, the Firm failed to identify and test any controls over the accuracy and/or completeness of the data and reports used in the operation of the controls.

- The Firm failed to perform sufficient procedures to test revenue. In particular, the Firm failed to perform substantive procedures that were specifically responsive to the assessed risks of fraud related to revenue. Also, the Firm designed its substantive procedures based on a level of reliance on controls that was excessive due to the deficiencies in the Firm's testing of controls described above. The Firm's primary procedure to test revenue was to develop an independent expectation of total revenue for the year. One of the factors used to develop the independent expectation was the year-end accounts receivable balance. The Firm failed to sufficiently test this factor, as its sample size used to select accounts receivable for confirmation was too small given the deficiencies in testing controls described above.

- Certain of the issuer's accounts receivable that it had acquired in business combinations were subject to extended payment terms that exceeded one year, and the issuer had determined the value of some of these accounts receivable by discounting the expected cash flows. The issuer recorded all of these accounts receivable as current assets, and the Firm failed to perform sufficient procedures to evaluate whether this presentation was appropriate in light of the payment terms and expected cash flows. Specifically, the Firm's procedures to test the presentation of these accounts receivable were limited to obtaining an issuer-prepared memorandum that focused on (1) management's expectations, at the time the credit was initially granted, that these amounts would be collected within a year, and (2) the average days that sales were outstanding for the acquired businesses, which was less than a year.

- The issuer completed several significant business combinations during the year. The Firm identified two review controls that were designed, in part, to address the valuation of the issuer's customer-relationship intangible assets acquired in business combinations. The Firm's testing of these controls was insufficient, as the Firm limited its procedures to observing evidence that the reviews had occurred, without evaluating whether the controls operated at a level of precision that would prevent or detect material misstatements.

- The Firm's substantive testing of the valuation of the acquired customer-relationship intangible assets, and of the amortization of these assets, was insufficient. Specifically –

    - For one of the acquisitions, the Firm's testing of certain assumptions underlying the expected margin projections the issuer used to value these assets was limited to comparing the assumptions to historical results, and noting that management's approach was conservative;

    - For all of the acquisitions, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the assumptions underlying the estimation of the customer attrition rates used in the valuations were reasonable; and

    - The Firm failed to evaluate the appropriateness of the issuer's amortization of these assets on a straight-line basis and over a period of time that differed from the period of cash flows used to value them.

A.8. Issuer H

In this audit, the Firm failed to identify a departure from GAAP related to the classification of revenue and cost of sales that it should have identified and addressed before issuing its audit report.

The Firm failed in the following additional 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 substantive procedures to test certain revenue throughout the year, as its procedures were limited to (a) obtaining an explanation from management for the increase in this revenue of 45 percent over the prior year, without obtaining corroboration of that explanation; (b) testing a sample of transactions from only the last two months of the year; and (c) performing an analytical procedure that was not precise enough to identify a potential material misstatement related to this revenue.

- The Firm identified fraud risks related to sales cut-off and revenue recognition, and selected a statistical sample of sales invoices in order to test revenue. The Firm's testing was insufficient, as the Firm compared less than ten percent of the selected invoices to appropriate supporting documentation; for the remaining invoices, the Firm relied on system-generated information that it had not tested.

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had identified and tested any controls over the existence of inventory held at storage facilities controlled by external parties.

A.9. Issuer I

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

- The Firm failed to sufficiently test controls over one significant type of revenue. Specifically, the Firm selected an application control that automatically calculated earned and unearned revenue, but the Firm's testing of this control was insufficient, as the testing addressed only that certain information had been entered into the application and not that the revenue had been appropriately calculated. The Firm also tested a review control that consisted of the comparison of recorded results to budgeted and prior-year information. The Firm's testing of this control was also insufficient, however, because (a) the Firm failed to evaluate the thresholds the issuer applied to identify unusual or unexpected trends or relationships, and the process for investigating any such trends or relationships; and (b) the Firm failed to identify and test any controls over the accuracy and completeness of information used in the operation of this control.

- The issuer used pricing information from its external investment managers to determine the recorded fair value of its AFS securities. For securities for which pricing information was not available from the external investment managers, the issuer used prices provided by the custodian of its securities, obtained non-binding broker quotes, or used pricing models. The Firm identified and tested two controls over the valuation of the AFS securities, but failed to sufficiently test either of these controls. Specifically –

    - The first control involved management both reviewing a comparison of the fair values provided by the investment managers to those provided by the custodian, and seeking additional information from the investment managers for securities with price differences over an established threshold. The Firm's interim testing of this control was insufficient because (a) it tested a sample of only one item; and (b) the information the issuer obtained for that security established only that the value should be lower than that of a different security for which the investment manager provided information. Further, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had selected any items in order to test this control at year end.

    - The second control included the review of the investment managers' reports by the issuer's investment committee. This control was the only control tested over the valuation of securities for which the issuer's custodian did not provide a price. The Firm's testing of this review was insufficient, because its procedures were limited to obtaining the reports from the investment managers that the investment committee reviewed, obtaining minutes of certain relevant meetings, and making inquiries of management, without evaluating whether the control operated at a level of precision to prevent or detect material misstatements.

- o The Firm failed to test whether the issuer's controls addressed the need for the issuer to have a sufficient understanding of how the external investment managers had priced the AFS securities without readily determinable fair values to enable the issuer to determine (a) whether the prices were reasonable and determined in accordance with GAAP and (b) whether the securities were appropriately classified within the fair value hierarchy.

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

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

- The Firm failed to sufficiently test controls over revenue. Specifically —

  - o For almost all of the issuer's revenue, the issuer used an automated calculation to divide invoiced amounts between revenue to be recognized and deferred revenue. The Firm elected not to test application controls over this automatic calculation, and the Firm did not identify and test any other controls that addressed the calculation of this revenue.

  - o The Firm's testing of the operating effectiveness of a review control over the reasonableness of monthly revenue and accounts receivable balances was limited to inquiring of management, determining whether there was evidence that a review had occurred, and noting that certain items had been resolved, without evaluating whether any variances identified in the review that were over the established threshold were appropriately investigated.

- o The Firm failed to identify and test any controls over the accuracy and completeness of reports used in the operation of certain controls it selected for testing.

- o For all but one of the controls over revenue that it selected for testing, the Firm used inquiry to update the results of its controls testing performed at interim dates to the year end. Limiting the procedures to inquiry was inappropriate, given that the Firm had determined that ITGCs, including change management controls, were ineffective for a portion of the update period and the Firm had identified a fraud risk related to revenue.

- The Firm failed to perform sufficient substantive procedures to test revenue, as it designed its substantive procedures based on a level of reliance on controls that was excessive due to the deficiencies in the Firm's testing of controls that are described above and the fact that the Firm determined that ITGCs were ineffective for a majority of the year.

  - o The Firm's testing included recalculating the amount of earned and unearned revenue for a sample of items, but the Firm did not compare these amounts to the corresponding recorded amounts.

  - o With respect to the Firm's substantive analytical procedures, the Firm's expectation of revenue was lower than the recorded balance by more than three times its established level of materiality, but the Firm failed to perform any procedures to evaluate whether this difference could represent a material misstatement. In addition, the Firm used certain data to develop its expectation that were derived from the accounting system, without performing any procedures to test the accuracy and completeness of the data.

- The Firm failed to perform sufficient procedures to test the issuer's controls over the valuation of certain derivative instruments that the issuer held, as the Firm did not identify and test any controls over the development of the assumptions used to estimate the fair value of these derivative instruments. In addition, the Firm failed to identify and test any controls over the disclosure of the derivative instruments as level 2 or 3 within the hierarchy set forth in Financial Accounting Standards Board ("FASB") ASC Topic 820, *Fair Value Measurement*.

A.11. Issuer K

In this audit, the Firm failed to sufficiently evaluate the appropriateness of the issuer's change in its method for determining its "current price" of natural gas, which was an important input to the issuer's evaluation of one of its oil and natural gas properties for impairment. Specifically, the Firm did not evaluate (a) whether the change was consistent with the applicable SEC guidelines for determining the "current price," and (b) whether it was appropriate for the issuer to use, when determining the value of the gas reserves, a "current price" that was higher than the average of the prices the issuer had received during the year.

A.12. Issuer L

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

- The issuer used information from an external pricing vendor to determine the recorded fair value of the majority of its fixed-maturity AFS investment securities. For securities for which pricing information was not available from the external pricing vendor, the issuer obtained prices from its external investment manager. The Firm failed to sufficiently test the issuer's controls over the valuation of the fixed-maturity AFS investment securities without readily determinable fair values. Specifically –

  - o With respect to the prices obtained from the external pricing vendor, the Firm selected for testing a control that consisted of the issuer's review of information provided by the issuer's external investment manager. The information reviewed included the investment manager's comparison, for certain of the issuer's investments, of prices obtained from the issuer's external pricing vendor to prices received from other pricing vendors, and the identification of investments for which variances between prices exceeded established thresholds. There was no evidence in the audit documentation, and no persuasive other evidence, that the

Firm had identified and tested controls to ensure that the prices used in the investment manager's comparison were the same as those the issuer used to record its fair values. In addition, the Firm failed to consider the effect of incorrect calculations by the investment manager of certain variances between prices on its conclusions regarding the severity of an identified deficiency in this control.

- The Firm failed to test whether the issuer's controls addressed the need for the issuer to have a sufficient understanding of how the external pricing vendor had priced the AFS investment securities without readily determinable fair values to enable the issuer to determine (a) whether the prices were reasonable and determined in accordance with GAAP and (b) whether the securities were appropriately classified within the fair value hierarchy.

- The Firm failed to identify and test any controls over the valuation of investments for which its external pricing vendor did not provide a price.

- With respect to the substantive testing of the valuation of the AFS investment securities, the Firm tested the value of the securities at an interim date and, to extend its conclusions to the year end, it developed expectations of year-end values for the AFS investment securities and tested some transactions that occurred after the interim testing. The procedures performed to extend the Firm's conclusions were not sufficient. Specifically –

  - The Firm's expectations were that the value of most of the investments it had tested at interim dates would not change significantly from the interim testing date to year end, and that, for some investment securities without readily determinable fair values, the value would not change by more than five percent of the value on the interim testing date. The Firm failed to obtain evidence to support these expectations, but nevertheless used them despite the diverse composition of the issuer's portfolio, the issuer's disclosure regarding market volatility in the last half of the year, and the decline in the credit rating of certain of the relevant investments.

- o The Firm's testing of the valuation of certain investments that were reclassified from level 2 to level 3 between the interim testing date and year end was not sufficient. Specifically, the Firm's year-end testing was limited to (1) comparing the value of these securities at the interim testing date to the value at year end and (2) obtaining a price for only one security from a pricing service, without performing any additional procedures to evaluate whether the price was reasonable and determined in accordance with GAAP.

- o The Firm failed to sufficiently test the valuation of the securities that the issuer acquired between the interim testing dates and year end, as its testing was limited to (a) testing the prices at the date of acquisition and (b) verifying that the change in price from the date of acquisition to year end was in line with its expectation, without obtaining evidence to support its expectation.

A.13. Issuer M

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

- The Firm failed to sufficiently test ITGCs relating to the issuer's general ledger application and its systems for processing loans and deposits. As a consequence of this failure, the Firm's reliance on certain system-generated reports, automated application controls, and information technology-dependent manual controls was excessive. The specific deficiencies in testing ITGCs are as follows –

  - o The Firm failed to test the operating effectiveness of the issuer's controls related to the granting and removal of user access to the issuer's general ledger application at the time that employees were hired, transferred, or terminated.

  - o The Firm failed to sufficiently test a control consisting of the annual review of user access profiles, as its testing was limited to one department and did not consider the fact that the control was based primarily on users' self-reviews.

- o The Firm identified as a control deficiency that certain program developers had inappropriate access to the issuer's systems used for processing loans and deposits and had the ability to make unauthorized changes to these systems. The Firm tested a manual control that it believed mitigated this risk, but failed to consider that this control was not designed to operate over all changes that developers with the inappropriate access might make to the systems. Further, the Firm failed to test whether other users had been granted similar inappropriate access to these systems.

- The issuer obtained pricing information for the majority of its AFS investment securities from external pricing vendors, and used this information to record the securities' fair value. The Firm failed to test whether the issuer's controls addressed the need for the issuer to have a sufficient understanding of how the external pricing vendors had priced its AFS investment securities without readily determinable fair values to enable the issuer to determine (a) whether the prices were reasonable and determined in accordance with GAAP and (b) whether the securities were appropriately classified within the fair value hierarchy.

- The Firm tested the value of the issuer's AFS investment securities at an interim date and, to extend its conclusions to the year end, it developed expectations of year-end values for these securities. With respect to certain AFS investment securities, the Firm used market indices to develop its expectations of the securities' value, but it failed to obtain evidence to support its assumption that the securities underlying the indices were comparable to the issuer's AFS investment securities. In addition, for one category of AFS investment securities, the Firm failed to perform procedures to support its conclusion that a difference between the recorded fair value and its expectation of fair value, which exceeded the Firm's level of materiality, did not represent a material misstatement.

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 –

- Due to the judgment involved in the process, the Firm identified a significant risk related to the appropriateness of the costs associated with converting raw materials into finished goods ("conversion costs") that were capitalized into inventory, but it failed to perform sufficient procedures to test controls that addressed this risk. Specifically, the Firm failed to identify and test controls that would address whether the conversion costs included in inventory were appropriate to be capitalized, including whether they had been allocated to the appropriate products, and instead focused on controls that addressed whether the judgments management had made were executed.

- The Firm failed to perform sufficient substantive procedures to test conversion costs, as it designed its substantive procedures, including its sample size for testing conversion costs, based on a level of reliance on controls that was excessive due to the deficiency in the Firm's testing of controls that is discussed above.

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

In connection with a foreign affiliated firm's audit of an issuer, the Firm audited the financial statements of a subsidiary of the issuer and tested the subsidiary's controls. The Firm failed to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit. Specifically –

- The Firm failed to test controls that would address (a) whether inventory was recorded at the lower of cost or net realizable value as required by the applicable accounting literature, and (b) the appropriateness of the costs associated with converting raw materials into finished goods ("conversion costs") that were included in the inventory valuation.

- The Firm's substantive procedures to test the appropriateness of the conversion costs capitalized into work-in-progress inventory were insufficient. Specifically, the Firm's procedures related to conversion costs were limited to recalculating variances between standard and actual costs for a sample of items, based on information in the subsidiary's accounting system, and comparing the recalculated amounts to amounts in the subsidiary's accounting system and to a schedule prepared by the subsidiary.

- The Firm failed to perform any substantive procedures related to the cost of finished goods inventory.

A.16. <u>Issuer P</u>

In this audit, the Firm failed in the following respects to sufficiently test the existence of inventory –

- The Firm determined that ITGCs over the issuer's perpetual inventory systems were ineffective. For two significant locations, the issuer used cycle-count procedures to determine inventory quantities. The Firm tested controls over the issuer's cycle-count procedures in order to rely on these controls with respect to the existence of this inventory. The Firm's testing of the cycle-count procedures, however, was not sufficient. Specifically –
    - The Firm failed to test the accuracy and/or completeness of the system-generated reports and spreadsheets that were used in, and that the Firm used to evaluate, the cycle-count procedures, including those that were used to address the accuracy and frequency of the counts.
    - The Firm's sample for its interim testing of the cycle-count procedures, which operated on a daily basis, was only three days. The Firm did not have a reasonable basis for limiting its sample to three days, given that it (a) had assessed the "risk of failure" of these controls over certain inventory as "higher," (b) had determined that the relevant ITGCs were ineffective, and (c) relied on the results of its testing of cycle-count controls to reduce the extent of the Firm's substantive procedures.
    - There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed any procedures to extend its audit conclusions related to the cycle-count procedures from the dates of its interim testing to the year end.

- For a third significant location, the issuer conducted full physical counts to determine the quantity of its inventory. The Firm, however, failed to perform any testing of the existence of the inventory at this location.

A.17. Issuer Q

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR. The issuer used certain forecasted financial information to evaluate goodwill and other intangible assets for impairment, and to determine the amount of a substantial impairment charge recorded during the year. The Firm failed to identify and test any controls over the development of the forecasted financial information.

B. Auditing Standards

Each of the deficiencies described in Part I.A of this report represents circumstances in which the Firm failed to comply with the requirement to obtain sufficient appropriate evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with applicable accounting principles, and/or for its opinion concerning whether the issuer maintained, in all material respects, effective internal control over financial reporting. Each deficiency relates to several applicable standards that govern the conduct of audits.

AU 230, *Due Professional Care in the Performance of Work* ("AU 230") requires the independent auditor to plan and perform his or her work with due professional care. AU 230 and Auditing Standard ("AS") AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS No. 13") specify that due professional care includes the exercise of professional skepticism. This is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13 requires the auditor to design and implement audit responses that address the identified risks of material misstatement, and AS No. 15, *Audit Evidence* ("AS No. 15") 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 and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in support of the related conclusions.

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS No. 5") and AS No. 13 establish requirements regarding testing and evaluating internal control over financial reporting. In an audit of internal control over financial reporting in an integrated audit, AS No. 5 requires the auditor to plan and perform the audit to obtain appropriate evidence that is sufficient to support the auditor's opinion on internal control over financial reporting as of the date of that opinion. AS No. 13 requires that, if the auditor plans to assess control risk at less than the maximum and to base the nature, timing, and extent of substantive audit procedures on that lower assessment, the auditor must obtain evidence that the controls tested were designed and operating effectively during the entire period for which the auditor plans to rely on controls to modify the substantive procedures.

The deficiencies described in Part I.A of this report relate to one or more of the provisions referenced above, and in many cases also relate to the failure to perform, or to perform sufficiently, certain specific audit procedures that are required by other applicable auditing standards. The table below lists the specific auditing standards that are primarily implicated by the deficiencies identified in Part I.A of this report. The broadly applicable aspects of AS No. 5, AS No. 13, AS No. 15, and AU 230 discussed above are not repeated in the table below.[4/]

PCAOB Auditing Standards	Issuers
AS No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*	A, B, D, E, F, G, H, I, J, L, M, N, O, and Q
AS No. 11, *Consideration of Materiality in Planning and Performing an Audit*	C
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	B, D, G, H, J, L, M, O, and P
AS No. 14, *Evaluating Audit Results*	G and H
AS No. 15, *Audit Evidence*	P
AU 316, *Consideration of Fraud in a Financial Statement Audit*	B
AU Section 326, *Evidential Matter*	A and F

[4/] This table does not necessarily include reference to every auditing standard that may have been implicated by the deficiencies included in Part I.A.

PCAOB Auditing Standards	Issuers
AU Section 328, *Auditing Fair Value Measurements and Disclosures*	B and D
AU Section 329, *Substantive Analytical Procedures*	B, G, H, and J
AU Section 331, *Inventories*	P
AU Section 342, *Auditing Accounting Estimates*	D, G, and K
AU Section 350, *Audit Sampling*	B and N

C. General Information Concerning PCAOB Inspections

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

The inspection team selects the audits and aspects to review, and the Firm is not allowed an opportunity to limit or influence the selections. In the course of reviewing aspects of selected audits, the inspection team may identify matters that it considers to be deficiencies in the performance of the work it reviews. Those deficiencies may include failures by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[5/] as well as

[5/] When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with applicable accounting principles, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), 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.

failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures. It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audit work, or the relevant issuers' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

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

In some cases, the conclusion that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS No. 3, *Audit Documentation* ("AS No. 3") 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.

Inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on previously expressed audit opinions.[6/]

[6/] The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements. Failure by a firm to take appropriate actions, or a firm's misrepresentations in

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies, and processes related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following five areas (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining clients, including the application of the Firm's risk-rating system; (4) processes related to the Firm's use of audit work that the Firm's foreign affiliates perform on the foreign operations of the Firm's U.S. issuer audit clients; and (5) the Firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to weaknesses in quality control.

END OF PART I

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responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

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.[7/]

[7/] The Board does not make public any of a firm's comments that address a nonpublic portion of the report. 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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July 22, 2013

Ms. Helen A. Munter
Director - Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Response to Part I of Public Company Accounting Oversight Board (PCAOB) Draft Report on 2012 Inspection of KPMG LLP

Dear Ms. Munter:

We are pleased to provide our response to Part I of the PCAOB's Draft Report on the 2012 Inspection of KPMG LLP dated June 20, 2013 ("Draft Report"). We remain committed to full cooperation with the PCAOB, and to our shared objectives of continually improving audit quality, building confidence in the auditing profession and meeting our responsibilities to investors and other participants in the capital markets system. We believe that the PCAOB's inspection process serves to assist us in identifying areas where we can continue to improve our performance and strengthen our system of audit quality control. We appreciate the professionalism and commitment of the PCAOB staff and value the important role the PCAOB plays in improving audit quality.

We conducted a thorough evaluation of the matters identified in the Draft Report and addressed the engagement-specific findings in a manner consistent with PCAOB auditing standards and KPMG policies and procedures.

We remain dedicated to evaluating and improving our system of audit quality control, monitoring audit quality and implementing changes to our policies and practices in order to enhance audit quality. We understand our responsibility to the capital markets and are committed to continually improving our firm and working constructively with the PCAOB to improve audit quality.

Very truly yours,

KPMG LLP

John B. Veihmeyer
Chairman and Chief Executive Officer

James P. Liddy
Vice Chair, Audit

cc: Mr. James R. Doty
Mr. Lewis H. Ferguson
Ms. Jeanette M. Franzel
Mr. Jay D. Hanson
Mr. Steven B. Harris