

Report on
2004 Inspection of BDO Seidman, LLP

Issued by the
Public Company Accounting Oversight Board

November 17, 2005

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**

Preface to Reports Concerning Annually Inspected Firms

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

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

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

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

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

2004 INSPECTION OF BDO SEIDMAN, LLP

In 2004, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted an inspection of BDO Seidman, LLP ("BDO" or "the Firm"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report, Appendix B, and portions of Appendix C. Appendix B provides an overview of the inspection process. Appendix C consists of the Firm's comments, if any, on a draft of the report.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

^{2/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") performed an inspection of BDO from May 2004 to July 2004. The inspection team performed field work at BDO's national offices in New York City and Chicago (collectively, "National Office(s)") and at six of its 31 practice offices.^{3/} Appendix B to this report provides a description of the procedures the inspection team performed.

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

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

^{3/} The inspection team reviewed audit engagements, as described in Appendix B, at five of the Firm's practice offices and conducted a review of one engagement in a sixth practice office as part of evaluating the conduct of the Firm's internal inspection program.

^{4/} 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 GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of selected audits performed by the Firm. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

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

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions,^{5/} and failure to take such actions could be a basis for Board disciplinary sanctions. In response to the inspection team's identification of deficiencies, the Firm, in some cases, performed additional procedures or supplemented its work papers. In some instances in which the inspection team identified GAAP departures, follow-up between the Firm and the issuer led to a change in the issuer's accounting or disclosure practices or led to representations related to prospective changes.^{6/}

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. In some of those audits, that conclusion followed from the omission, or insufficient performance, of a single procedure, while other audits included

^{5/} See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

^{6/} The Board inspection process generally did not include review of such additional procedures or documentation, or of such revised accounting, although future Board inspections of the Firm may, as appropriate, include further review of any of these matters.

more than one such failure. The deficiencies that reached this degree of significance are described below (without identifying the issuers).^{7/} The deficiencies are discussed here on an audit-by-audit basis, with the exception of certain types of deficiencies that were observed to recur in multiple audits and are therefore grouped together.

Issuer A

During one audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The issuer misclassified its revolving line of credit as a long-term liability rather than as a current liability. The issuer's classification was not in accordance with Emerging Issues Task Force ("EITF") Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.^{8/}

Revenue recognition

In three of the engagements reviewed, deficiencies in the auditing of revenue recognition resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinion:

- During its second quarter, one issuer recognized as other income the remaining portion of deferred revenue related to agreements made three years previously granting certain distribution rights and technology licenses. In previous years, revenue from these agreements was recognized on a straight-line basis over the life of the agreements. The Firm failed to evaluate, or failed to include in the work papers evidence that it had evaluated, the propriety of either the original method of revenue recognition or the recognition of all the remaining deferred revenue in the second quarter. The recognition of the remaining deferred revenue as

^{7/} 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.

^{8/} The issuer subsequently restated its prior year's balance sheet to classify the debt as a current liability.

other income reduced the issuer's net loss by approximately 18 percent. (Issuer B)

- The Firm requested confirmations of an issuer's accounts receivable. The Firm failed, however, to request that the customers confirm key contract terms (e.g., rights of return) or the absence of side agreements, even though the work papers implied that the customers had been requested to confirm the terms and stated that the issuer's revenue agreements did not contain standard terms and conditions. In addition, the engagement team told the inspection team that the issuer granted its largest customer the right to return unsold product. (Issuer C)
- The Firm failed to review an issuer's contracts with its major customers to evaluate whether the issuer's revenue recognition practices were appropriate. (Issuer D)

Issuer F

In one of the engagements reviewed, deficiencies in the auditing of fair value assumptions resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinion. The Firm failed to test, or failed to include evidence in the work papers that it had tested, the assumptions an issuer made when valuing the warrants it had granted to its creditors in exchange for an extension of the payment terms and other modifications to its debt. The issuer valued the warrants to compute the discount on the modified debt. The unamortized debt discount equaled 19 percent of the issuer's liabilities at year end.

Issuer G

In one of the engagements reviewed, deficiencies in the testing of internal control resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinion. The Firm failed to change its level of controls assurance from "moderate" to "basic" when it identified certain weaknesses in the issuer's IT general controls.^{9/} As a result, the Firm performed insufficient audit work on accounts receivable and inventories.

^{9/} Under the Firm's audit methodology, controls reliance may be assessed at "no assurance," "basic," "moderate," "intermediate," and "high."

Fixed Assets and Inventory

In three of the engagements reviewed, deficiencies in the substantive audit procedures related to fixed assets or inventory resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinion:

- When auditing one issuer's demonstration equipment, which represented eight percent of the issuer's total assets and was held at potential customers' locations, the Firm determined that the information on a sample of shipping documents agreed with the issuer's fixed assets list. The Firm failed, however, to send confirmation requests to a sample of the potential customers or observe a sample of the equipment held by the potential customers to determine whether the customers still had the equipment and its physical condition. (Issuer H)
- The Firm failed to test the overhead costs that an issuer capitalized as part of the costs of its fixed asset additions. The overhead costs represented approximately 15 percent of the year's fixed asset additions and three percent of total assets. (Issuer I)
- One issuer allocated certain overhead costs to its raw materials inventory. The Firm failed to test the appropriateness of the costs that were included in the raw materials overhead cost pool and to recompute the raw materials overhead rate. Overhead costs represented 16 percent of inventory, and net inventory represented 26 percent of the issuer's total assets. (Issuer C)
- The issuer analyzed its slow-moving inventory using a non-routine report, generated from its inventory file. The analysis formed the basis for the issuer's reserve for inventory obsolescence. The Firm failed to perform tests of controls or substantive audit procedures to verify that the report was complete and accurate. In addition, the Firm failed to obtain sufficient evidence to corroborate the reasonableness of the resulting reserve for inventory obsolescence. The gross amount of inventory was 67 percent of total assets, and the reserve was 61 percent of the gross amount. (Issuer C)

Issuer J

In one engagement reviewed, deficiencies in auditing related to the impairment of goodwill resulted in the Firm failing to obtain sufficient competent evidential matter to support its audit opinion. The issuer performed an interim goodwill-impairment analysis because it sold a large portion of its operations and concluded that a small portion (approximately seven percent) of its goodwill was impaired. The Firm failed to test or challenge the assumptions the issuer made when the issuer assessed the goodwill for impairment. In particular, the Firm failed to address why goodwill, which represented approximately one-third of the issuer's total assets, was not fully impaired in light of the issuer's deteriorating financial performance.

Issuer K

In connection with the Firm's consideration of one issuer's ability to continue as a going concern, the Firm failed to evaluate, or failed to include in the work papers evidence that it had evaluated, management's plans for dealing with the issuer's adverse liquidity position, as required by AU 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. The issuer had negative working capital, shareholders' deficit, recurring net losses, a significant portion of its debt maturing within the next 12 months, and a cash deficit from operations that primarily was funded through advances from its majority shareholder and private placements of its common stock.

B. Review of Quality Control System

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

Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

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

APPENDIX B

THE INSPECTION PROCESS

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

1. Review of Selected Audit Engagements

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

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

When the inspection team identified a potential issue, it discussed the issue with members of the audit engagement team. If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other documentation, the inspection team ordinarily requested the engagement team to consult with the Firm's professional practice personnel in the National Offices.

2. Review of Seven Functional Areas

The inspection team conducted the procedures related to the review of the seven functional areas primarily at the Firm's National Offices. With respect to six of the functional areas, the inspection team also conducted procedures at certain of the Firm's practice offices. The review of the seven functional areas was designed to provide a knowledge base on which to draw in planning future inspections, comparing firm practices, and measuring progress over time. The inspection team also performed procedures to identify possible defects in the Firm's system of quality controls. A more detailed description of the scope with respect to each of the seven functional areas follows.

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

The inspection team evaluated the Firm's policies and procedures related to partner evaluation; partner compensation; nomination and admission of new partners; discipline; and termination of partners. The inspection procedures were designed to provide a basis for an assessment of whether the design of these processes could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm.

In evaluating these policies and procedures, the inspection team interviewed 12 members of the Firm's leadership at its National Offices, as well as members of leadership and audit partners in practice offices. In addition, the inspection team analyzed schedules provided by BDO that detailed information on each partner, including the partner's office location and business unit, number of years as a partner, and compensation history. The inspection team also reviewed a sample of partners' personnel files, including files of newly admitted partners, partners who resigned or took early retirement, and partners who received bonus compensation.

b. Review of Independence Policies

The objectives of the inspection procedures in this area included gaining an understanding of and evaluating the Firm's policies and procedures relating to its compliance with independence requirements with respect to personal investment holdings; the provision of non-audit services to issuer clients; BDO's participation in business ventures, alliances, and arrangements; and contingent fee arrangements. To accomplish these objectives, the inspection team reviewed the Firm's policies, procedures, guidance, and training materials pertaining to these independence matters. The inspection team reviewed a sample of annual independence confirmations from BDO personnel. The inspection team also reviewed BDO's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures, including the results of the most recent review of practices regarding training of newly hired personnel and independence confirmations; examined the Firm's independence consultation process, which included reviewing a sample of independence consultations; and reviewed information concerning the Firm's existing business ventures, alliances and arrangements, as well as the Firm's process for establishing such enterprises. The inspection team also interviewed numerous National Office and practice office personnel regarding the Firm's independence policies, practices and procedures.

For each of the engagements selected for review, the inspection team reviewed relevant information to identify any non-audit services performed for the issuer, including whether any of the services involved contingent fee arrangements; to determine whether the fees for the services provided were classified appropriately in the issuer's proxy statement; and to determine whether the issuer was involved in any business ventures, alliances, or arrangements with the issuer. In addition, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

c. Review of Client Acceptance and Retention Policies

The primary objectives of the inspection procedures in this area were to evaluate whether the Firm's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and that it appropriately considers the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed the

Firm's policies, procedures and forms related to client acceptance and continuance; evaluated documentation related to new clients, including two of the engagements selected for inspection, and to clients that had recently changed auditors from the Firm; and interviewed members of the Firm's leadership, both at the National Offices and the practice offices.

d. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of the Firm's annual internal inspection program in enhancing audit quality, as well as to assess the Firm's compliance with the quality control standards adopted by the Board. To meet those objectives, the inspection team reviewed policies, procedures, guidance and forms at the Firm's National Offices related to its internal inspection program, documentation of the results of the current and two prior years' inspection programs, and steps taken by BDO in response to those results. The inspection team also interviewed the Firm's leadership concerning the process and effectiveness of its internal inspection program.

The inspection team reviewed and tested the conduct of the internal inspection program in one practice office where BDO had conducted an internal inspection. These procedures included evaluating the qualifications of the Firm's inspectors, reading the inspectors' comments, reviewing the results of the inspectors' review of certain Firm-wide functional areas, and interviewing both area leadership and selected audit personnel concerning the internal inspection program. In addition, for one of the engagements that the internal inspectors had reviewed, the inspection team reviewed documentation of the internal inspectors' review of the engagement, reviewed certain aspects of the audit work papers, and discussed with BDO any significant differences in the results of the inspection team's review and that of the Firm's internal inspectors.

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

The objectives of the inspection procedures in this area were to obtain an understanding of the Firm's processes for establishing and communicating audit policies, procedures and methodologies, including training and Information Systems policies and procedures; and to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance.

Toward those objectives, the inspection team reviewed documentation relating to the Firm's method for developing policies and procedures, as well as internal guidance and/or training materials distributed to audit personnel with respect to recent changes in requirements and to selected specific areas. This review included analyzing the Firm's methodology for using IS audit specialists and the processes for identifying and documenting controls, assessing control risk, and testing controls; determining the effects of the control risk assessment on substantive procedures; and using computer assisted audit techniques. The inspection team also evaluated the effectiveness of the design of the Firm's processes for monitoring developments that could affect the Firm's audit policies, procedures and methodologies.

f. Review of Policies Related to Foreign Affiliates

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

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

g. Tone at the Top

The primary objective of the review of the Firm's "tone at the top" was to assess whether actions and communications by the Firm's leadership demonstrate a commitment to audit quality and compliance with the Act, the rules of the Board, the rules of the SEC, and PCAOB standards in connection with the Firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the inspection team reviewed and analyzed information at the Firm's National Offices. Such information included the Firm's code of conduct; documents relating to measuring and monitoring audit quality; descriptions of the duties of, and relationships

between and among, the Firm's staff and leadership; public company audit proposals; internal and external communications from management; descriptions of the Firm's financial structure and business plan; and agendas and minutes of the Firm's board of directors. In addition, the inspection team interviewed 18 members of the Firm's leadership team.^{10/}

The inspection team conducted interviews at six of the Firm's practice offices to obtain perspectives on communications from the Firm's leadership relating to audit quality and tone at the top. The inspection team interviewed members of the leadership at each of these offices, as well as certain audit partners and senior managers assigned to engagements that were reviewed. In addition, the inspection team conducted four focus group meetings in those offices to assess the participants' understanding of, among other things, the messages conveyed by the National Offices, practice office leadership and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top. Two of these focus group meetings consisted of audit senior managers and audit managers, and two were composed of audit senior accountants and audit staff.

^{10/} This team includes Associate Directors of Assurance, members of BDO's board of directors and National Office personnel.

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 Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act 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. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements, in the draft, that the Board corrects in the final 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. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.

**Response to Part I of Draft Report on
2004 Inspection of
BDO Seidman, LLP**





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September 21, 2005

Mr. George H. Diacont
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
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**Re: Response to Part I of the
Draft Report on 2004 Inspection of BDO Seidman, LLP**

Dear Mr. Diacont:

We welcome this opportunity to provide our response to Part I of the draft Report of the Public Company Accounting Oversight Board ("PCAOB") on the 2004 inspection of BDO Seidman, LLP ("the Firm") and request that this letter be made part of the final Report.

We share the PCAOB's goal of using the inspection process as a strong catalyst for improving audit quality and, consequently, the reliability of financial reporting. In that regard, we appreciate the considerable value derived from the inspection process because an inherent part of our audit practice involves continuous improvement. To that end, we assessed the detailed comments we received from the inspection team in 2004 and communicated those findings to our audit professionals last October and November. In addition, we have provided specific guidance and held training sessions on topics related to matters raised during the inspection.

As appropriate in today's environment, the inspection team applied extremely rigorous standards in the engagement reviews. We believe that such an inspection approach is an effective means of encouraging audit firms to elevate their performance levels from compliance with applicable auditing standards to implementation of best practices.

Recognizing the importance and value of the inspection process, we cooperated with the inspection team to our fullest extent. We did this with the understanding that, while there were, at times, what we considered to be reasonable differing views between the inspection team and the Firm's engagement teams and senior assurance partners as to audit approaches or materiality, as would be expected based on the judgmental nature of such matters, consideration of different views is a useful means of promoting best practices.

The draft Report does appropriately recognize that the inspection process is designed to identify deficiencies and that, based on the limited selection of audits inspected, findings are not necessarily reflective of a firm's practice in general. As such, the format of the draft



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PCAOB
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Report produced by this process does not lend itself to a portrayal of the overall high quality of our audit practice. Further, the design of the draft Report provides condensed information regarding the findings so there is no description of the procedures that were performed in the applicable areas at the time of the audits or other information that may provide additional context for understanding the nature or magnitude of the findings.

The engagements reviewed by the inspection team typically involved hundreds of decisions, many of which may be subject to different reasonable interpretations. In that regard, the inspection included certain of the largest issuers audited by the Firm, for which there were relatively insignificant or no findings. In addition, it should be noted that none of the comments of the inspection team resulted in restatements of financial statements, except for the single instance involving EITF Issue 95-22, the effect of which had no impact on the issuer's results of operations.

It should also be recognized that the sufficiency of evidential matter required to support an informed audit opinion is determined through the exercise of the auditor's professional judgment after a careful study of the particular circumstances. While robust and thoughtful documentation is an important element of the audit process and review thereof, it is also one of the more difficult areas in which to reach a common understanding of what is sufficient because of the variety of judgments involved in that analysis by professionals having different levels of knowledge of the issuers' businesses. Nevertheless, with the subsequent issuance of Auditing Standard No. 3, we have developed substantial additional guidance and training in this area intended to ensure adherence to the new, more stringent, standard.

We want to reiterate the seriousness with which we view the inspection comments and that we are committed to improving our performance wherever possible.

We appreciate this opportunity to provide our response to the Board and we look forward to further dialogue on the most effective means of enhancing audit quality. If you have any questions regarding this letter, please contact Wayne Kolins at (212) 885-8595.

Respectfully submitted,

BDO Seidman, LLP