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Report on
2005 Inspection of BDO Seidman, LLP

Issued by the
Public Company Accounting Oversight Board

November 30, 2006

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED
FROM THIS DOCUMENT IN ORDER TO COMPLY WITH
SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

PCAOB RELEASE NO. 104-2006-200



Preface to Reports Concerning Annually Inspected Firms

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("PCAOB" or "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 of financial statements and of internal control over financial reporting. 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 reporting on internal control, 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 the annually inspected 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.



During 2005, the Board monitored the implementation of the provisions of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2") by annually inspected U.S. firms. Among other things, that monitoring included Board staff meetings with these firms to discuss their methodology and to discuss opportunities to enhance the effectiveness and efficiency of audits of internal control. As the Board has previously stated, the Board believes that audits performed under the difficult circumstances of the first year of implementation of AS No. 2 were often not as efficient as the standard intends, and as the Board expects them to be in future years. The primary reasons for this failure to achieve expected efficiencies are described in the Board's Report on the Initial Implementation of Auditing Standard No. 2 ("the Report").^{1/} In general, as described in the Report, in the 2005 inspections of certain firms, the Board's inspectors observed that, in a significant number of the engagements they selected for inspection of the application of AS No. 2, the auditors did not integrate their audits of internal control with their audits of the financial statements; did not use a top-down approach; and did not alter the nature, timing, and extent of their procedures to reflect the level of risk within a given area.

^{1/} See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (November 30, 2005).



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 U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



2005 INSPECTION OF BDO SEIDMAN, LLP

In 2005, the 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 includes the Firm's comments, if any, on a draft of the report.^{2/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{3/} 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.

^{2/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

^{3/} 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 the Firm from May 2005 to October 2005. The inspection team performed field work at the Firm's national offices in New York City and Chicago (collectively, "National Office(s)") and at 11 of its approximately 33 U.S. practice offices.

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 audits of financial statements and of internal control over financial reporting and the review of 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 or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

^{4/} When the Board becomes aware 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's practice is to report 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 of financial statements and of internal control over financial reporting 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 some cases, errors that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the 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 claims to have performed the procedure. PCAOB Auditing Standard No. 3 ("AS No. 3"), in effect for most of the audits reviewed in the inspection,^{5/} 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.^{6/} For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

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,^{7/}

^{5/} Auditing Standard No. 3, *Audit Documentation*, applies to audits with respect to fiscal years ending on or after November 15, 2004.

^{6/} See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

^{7/} 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*

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.^{8/}

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient 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 more than one such failure. The deficiencies that reached this degree of significance are described below (without identifying the issuers).^{9/} The deficiencies are discussed here on an audit-by-audit basis.

Issuer A

In this audit, the Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. As consideration for an acquisition, the issuer issued shares to the former officers and employees of the acquired company that were forfeitable if the individuals did not remain employed by the issuer for three years. The issuer treated these forfeitable shares as part of the acquisition purchase price (which increased goodwill) rather than as deferred compensation (which would be amortized to expense over the three-year period). The

(both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

^{8/} 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.

^{9/} The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

issuer's accounting treatment was not in accordance with EITF 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*. If the forfeitable shares had been treated as deferred compensation and amortized to expense, the issuer's pre-tax earnings would have been approximately 12 percent lower.

Issuer B

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The issuer entered into a complex multiple-year, multiple-element agreement to license patents to another party, including specified current patents and a patent to be designated in the future by the other party. The Firm's auditing of the issuer's revenue recognition regarding this transaction was deficient in several ways –
 - The parties designated as "recoupable consideration" an amount equal to approximately 40 percent of the consideration payable to the issuer for the technology license. The agreement provided for a period of time ("the Recoupment Period") during which the other party could apply the recoupable consideration toward future purchases of product from the issuer or to satisfy royalty obligations to the issuer incurred as a result of using the licensed technology. The issuer determined to recognize the recoupable consideration as revenue evenly over the Recoupment Period. This accounting was incorrect, since the earnings process for the recoupable fees would only be completed as the issuer sold qualifying products to the other party or as the issuer earned royalties from the other party, or upon the expiration of the Recoupment Period. The Firm should have identified and appropriately addressed the improper accounting.
 - The agreement obligated the other party to transfer certain of the issuer's content to the other party's hardware and software platform for subsequent purchase by the issuer of minimum specified quantities of the resulting product. The high end of the range of the issuer's total purchase price of product from the

other party was estimated to be approximately 50 percent of the total consideration that the issuer would receive under the agreement. Described another way, of the consideration that the issuer receives *other than* the recoupable consideration described above, the agreement obligates the issuer to use up to approximately 85 percent of that amount to purchase from the other party product that incorporates the issuer's content. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the appropriateness of the issuer's revenue recognition approach (recognizing revenue evenly over the period during which the other party could designate an additional patent for inclusion in the licensing agreement) for this component of the consideration.

- In addition, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had (1) evaluated an analysis prepared by the issuer and its consultant indicating that the appropriate accounting for the agreement was other than that eventually adopted by the issuer; (2) evaluated the adequacy of the issuer's financial statement footnote disclosures concerning the agreement; and (3) obtained clarification of certain ambiguities in the agreement, such as the extent, if any, to which the product to be produced by the other party (and to be purchased by the issuer) would (or was expected to) incorporate not only the issuer's content but also the issuer's technology that was being licensed to the other party.
- The Firm's audit work on the appropriateness of revenue recognition included the testing of a sample of individually significant sales. The Firm's work papers identified four transactions where revenue was recognized during the last month of a quarter despite indications that installation was not complete. These included one transaction where payment of 25 percent of the purchase price was tied to the completion of installation. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed whether incomplete installation warranted adjustment to the recorded sales. The Firm's work papers also identified a transaction, involving the sale of equipment and software licenses, for which the revenue that the issuer recognized included revenue related to post-contract support.

There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether some portion of that revenue should have been deferred.

- The issuer's and the Firm's estimates of the allowance for doubtful accounts were based, in part, on the aging of the issuer's accounts receivable. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed tests of controls or substantive audit procedures to test whether the individual billings were aged properly and whether the totals of the aging categories were correct. Although the Firm tested program change controls, those tests were not sufficient to eliminate the need for the Firm to test the aging report or the controls related to producing the aging report, since the Firm had identified deficiencies in those controls during the year.
- The work papers include documentation of regulatory sanctions against the issuer resulting from alleged financial and accounting irregularities during the preceding two years. The Firm's audit planning appropriately identified fraudulent revenue recognition and customer side agreements as fraud risk factors. There was no evidence in the audit documentation, and no persuasive other evidence, however, that the Firm had performed procedures in response to the risk of side agreements. There also was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had discussed specific fraud risks with members of management. As a result of these deficiencies, as well as the deficiencies noted in the preceding paragraphs, the Firm's revenue testing did not respond appropriately to the identified risks.
- The issuer had an indefinite-lived intangible asset related to an acquisition made in 1998. The Firm observed that the net book value of the indefinite-lived intangible asset had been increased inappropriately when, in 1998, the acquiree's opening balance sheet deferred tax liabilities were treated as an increase in the identifiable intangible asset. When the Firm conducted its impairment testing of the indefinite-lived intangible asset, the Firm considered this misstatement in reaching the conclusion that the asset was not impaired. The Firm, however, failed to recognize the need for an adjusting entry to correct the misclassification between the intangible asset and goodwill. In addition, there was no evidence in the audit documentation, and no

persuasive other evidence, that the Firm had evaluated whether the intangible asset continued to be an indefinite-lived non-amortizing asset rather than a finite-lived amortizing asset. Finally, the Firm's testing of goodwill for impairment did not consider that the amount of goodwill that should have been subject to testing was greater than the recorded goodwill.

Issuer C

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The issuer's revenue was derived from the sale of products, services, and consumables. Some sales were made directly to end-users while other sales were made to distributors. The Firm's work papers included a revenue recognition checklist and excerpts from SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* ("SAB No. 104"); however, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had conducted, for each category of sales, a sufficient analysis of how the issuer's transaction terms governing matters such as payment, product acceptance, transfer of title, and installation affect the recognition of revenue under SAB No. 104. For a category of sales representing approximately 34 percent of total sales, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the effect of the issuer's standard sales agreement, which states that title does not transfer until all payments have been made, on the issuer's practice of recognizing revenue at the time of shipment. There also was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed whether, in cases where payment was tied to installation by the issuer, the issuer's installation services were inconsequential and perfunctory and thus whether the issuer's practice of recognizing revenue upon shipment was appropriate. The Firm's work papers noted that certain sales to governmental entities are subject to acceptance provisions. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed the effect of these acceptance provisions on revenue recognition. For other categories of sales, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the appropriateness of the issuer's recognition of revenue from 1) sales to international distributors, and 2) a separate product line that is shipped directly to end-users.

- The Firm documented its consideration as to whether a specific transaction qualified for sales-type lease accounting. The Firm's documented description of the facts indicates the Firm's understanding that the rental payments were contingent upon the volume of equipment usage. That understanding – which, if correct, would have meant that the issuer's use of sales-type lease accounting was a departure from GAAP – was incorrect, but the Firm did not learn that it was incorrect until after issuing the audit report (and after the inspection).^{10/} Before issuing its audit report, the Firm both failed to identify and address that the issuer's accounting was incorrect on the facts as the Firm understood them, and failed to obtain an accurate understanding of the facts.

Issuer D

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion -

- The issuer engaged an outside valuation firm to conduct its goodwill impairment analysis. That fair value analysis, which formed the basis of the issuer's valuation of goodwill as reflected in the financial statements, was based on management's assumptions. While the Firm's work papers contain documentation of these management assumptions, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the reasonableness of these management assumptions.
- Two of the issuer's segments were composed of multiple businesses and/or product lines. The issuer conducted its goodwill analysis at the segment level. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had assessed whether the issuer's goodwill impairment analysis should have been conducted at the segment level or one level below the segment level.
- The issuer analyzed its slow-moving and excess inventory using a report generated from its information systems. This report grouped the inventory

^{10/} Subsequent to the inspection, the Firm double-checked the facts and noted that the rents were in fact fixed in nature rather than variable, and thus that the lease transaction did qualify for sales-type lease accounting.

into specific categories, largely based on the age and nature of the inventory. The Firm tested the recovery rate percentages the issuer used to estimate the net realizable value of the inventory in specific categories. There was no evidence in the audit documentation, and no persuasive other evidence, however, that the Firm had performed tests of controls or substantive audit procedures to assess whether the amount of inventory that the issuer included in each category was complete and accurate.

Issuer E

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its opinion –

- The Firm selected a sample of accounts receivable for confirmation. The issuer brought to the Firm's attention a significant billing error that affected an invoice in the sample. The Firm looked for similar errors by inspecting credit memos in the subsequent period. Noting no similar errors, and considering its experience with the issuer and the results of its comparisons of accounts receivable to cash receipts, the Firm concluded that the error was isolated in nature and did not project the amount of the error to the total population. The absence of other similar corrected errors does not provide sufficient evidence that all similar errors had been identified and corrected or that the identified billing error was isolated in nature. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had conducted adequate procedures to determine whether similar undetected errors existed, particularly with respect to large uncollected accounts receivable. Had the error been included in the extrapolation of the sample results, the extrapolated error would have been greater than the Firm's estimate of materiality.
- The Firm agreed with the issuer's conclusion that certain costs related to a three-year customer contract should be deferred and amortized over the term of the contract rather than expensed as incurred. There was no evidence in the audit documentation, and no persuasive other evidence, that, in reaching that conclusion, the Firm had tested the accuracy of the issuer's representation regarding the nature of the costs.

Issuer F

The issuer has a rental fleet of equipment deployed at customer locations, as well as rental equipment available for deployment. The issuer's discussion of risk factors in its Annual Report on Form 10-K indicates that its rental fleet is exposed to the risk of non-renewal, reduced customer acceptance, and obsolescence. The Firm performed procedures to test the accuracy of the issuer's list of the equipment in its possession that was available for deployment. These procedures, however, did not address the completeness of the entire population of equipment that was available for deployment because the procedures did not address whether any customers were holding equipment that was not actively deployed. The procedures also did not address the risk that there may have been unrecorded disposals of equipment that continued to be reflected as equipment actively deployed at customer locations.

Issuer G

The issuer conducted a physical inventory at its retail stores near year end. The Firm observed the physical inventory at a sample of the stores and compared the results with the issuer's final inventory report at year end. There was no evidence in the audit documentation, and no persuasive other evidence, however, that the Firm had compared the results of the physical inventory at any of the issuer's other stores with the issuer's final inventory report at year end.

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, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for 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. issuer 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



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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 the Firm with applicable requirements and standards related to auditing issuers. This process included reviews of components of selected issuer audit engagements completed by the Firm. 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 control over audits. In addition, the inspection included reviews of the design of, and in some cases the application of, policies and procedures related to certain functional areas of the Firm that could be expected to influence audit quality.

1. Review of Selected Audit Engagements

The inspection team reviewed aspects of selected audits performed by the Firm. The inspection team chose the engagements according to the Board's criteria. The Firm 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 the Firm and the issuer's audit committee. With respect to certain engagements, the inspection team also interviewed the chairperson of the issuer's audit committee.

The inspection team also reviewed aspects of certain of the Firm's audits of internal control over financial reporting. For each audit engagement selected for this purpose, the inspection team reviewed the Firm's work papers and interviewed engagement personnel regarding the audit approach, including the use of a top-down

approach, the assessment of risk, the evaluation of management's assessment of internal control, and the integration of the audit of internal control over financial reporting with the audit of the financial statements. The inspection team also selected certain significant processes and, for those processes, reviewed the Firm's evaluation of the design effectiveness of controls, including the performance of walkthroughs, and the performance of tests of operating effectiveness of controls. For the selected engagements, the inspection team also reviewed the Firm's evaluation of any control deficiencies that the Firm identified during the Firm's audit of the issuer's financial statements.

When the inspection team identified a potential issue, it discussed the issue with members of the engagement team. If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other documentation, the inspection team issued a comment form on the matter and the Firm provided a written response to the comment form. In certain instances, if the inspection team was unable to resolve the issue through these processes, the inspection team requested that the engagement team consult with the Firm's National Director of Accounting. In many cases, this process resulted in resolution of the matter, either because the Firm agreed with the position the inspection team had taken and the Firm or the issuer took steps in light of the significance of the error to remedy the exception, or because the Firm was able to provide additional information that effectively addressed the inspection team's concerns.

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 seven functional areas, the inspection team also conducted procedures at certain of the Firm's practice offices. The inspection team performed these procedures both to identify possible defects in the Firm's system of quality control and, where applicable, to update the Board's knowledge of the Firm's policies and procedures in the functional areas. A more detailed description of the scope with respect to each of the seven functional areas follows.

a. Review of Partner Evaluation, Compensation, Admission, Assignment of Responsibilities, 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,

assignment of responsibilities, disciplinary actions, and termination of partners. The objective of the inspection procedures was to assess whether the design of these processes, as documented and communicated, could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm.

The inspection team interviewed 23 members of the Firm's leadership at its National Offices, as well as members of leadership and audit partners in practice offices, regarding these topics. In addition, the inspection team analyzed schedules provided by the Firm that detailed information on each partner, including the partner's office location, recent evaluation history, 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 evaluating the Firm's policies and procedures relating to its compliance with independence requirements with respect to the provision of non-audit services to issuer audit clients; Firm participation in business ventures, alliances, and arrangements; commissions and contingent fee arrangements; personal financial interests and the relationships of Firm professionals with issuer audit clients; and the provision of non-audit services related to issuer audit clients' compliance with Section 404 of the Act. 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 also reviewed the Firm's internal inspection program as it relates to monitoring compliance with the Firm's independence policies and procedures; tested the Firm's independence consultation process; 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.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, reviewed relevant information to identify any non-audit services performed for the issuer, including whether any of the services involved commissions or 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 Firm was involved in any business ventures, alliances, or arrangements with the issuer. In addition, for the sample, the inspection team read and evaluated the most recent letter pursuant to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*.

c. Review of Client Acceptance and Retention Policies

The 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 and to clients that had recently changed auditors from the Firm; and interviewed members of the Firm's leadership.

At the practice offices, the inspection team selected a sample from the engagements it reviewed and, for that sample, evaluated whether the client acceptance or continuance documentation was completed and approved in accordance with Firm policies; interviewed the audit partners and managers on these engagements concerning the reasons for accepting the issuer as a client or continuing to serve the issuer, the approval process, and whether specific risk mitigation steps were performed and documented in response to any identified risks; and assessed whether the audit planning documentation incorporated the specific actions, if any, contemplated in response to any identified risks.

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 related to the Firm's internal inspection program, documentation of the results of the current year's inspection program, and steps the Firm took 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 by performing field work in two practice offices where the Firm had conducted internal inspections. 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 a sample of the engagements that the internal inspectors had reviewed at these practice offices, the inspection team reviewed documentation of the internal inspectors' review of the engagements, reviewed certain aspects of the audit work papers, and discussed with the Firm 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 update the inspection team's understanding of the Firm's processes for establishing and communicating audit policies, procedures, and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; and to evaluate changes in audit policies that the Firm had made since the Board's most recent inspection of the Firm.

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 with respect to selected specific areas. 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 objective of the inspection procedures in this area was to evaluate the processes the Firm uses to ensure that the audit work that its foreign affiliates perform 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. Finally, with respect to a sample of the engagements reviewed, the inspection team reviewed the U.S. engagement team's supervision and control procedures concerning the audit work that the Firm's foreign affiliates performed.

g. Review of Tone at the Top

The 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 Office. 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; results of surveys of staff and clients; public company audit proposals; internal and external communications from management; and agendas and minutes of the Firm's board of directors. In addition, the inspection team interviewed numerous members of the Firm's leadership team.

The inspection team conducted interviews at five 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 certain of these offices, as well as certain audit partners and senior managers assigned to engagements that were reviewed.

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.^{11/}

^{11/} 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. In some cases, the result may be that none of the Firm's response is made publicly available.



BDO Seidman, LLP
Accountants and Consultants

**Response to Part I of Draft Report on
2005 Inspection of
BDO Seidman, LLP**





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October 24, 2006

Mr. George H. Diacont
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

**Re: Response to Part I of the
Draft Report on 2005 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 2005 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 2005, communicated those findings to our audit professionals in multiple training sessions, and provided specific guidance to them on topics related to matters raised during the inspection.

As appropriate in today's environment, the inspection team applied 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. 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 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 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



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provide additional context for understanding the nature or magnitude of the findings. Moreover, the engagements reviewed by the inspection team typically involved hundreds of decisions, many of which may be subject to different reasonable interpretations.

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 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. We have developed additional guidance and training in this area and continue to consider new means of ensuring that all of our audits incorporate robust and thoughtful documentation.

With respect to the matters described for Issuer A and in the first bullet item for Issuer B, as we discussed with the PCAOB staff during the inspection, we believe that the accounting treatments used by the issuers were appropriate. In that regard, with respect to Issuer A, EITF 95-8 includes a variety of factors where judgment is to be applied in evaluating whether forfeitable shares should be treated as compensation or additional purchase price. While forfeiture of shares upon termination is a strong indicator of compensation, in this instance we concluded, after following appropriate consultation procedures during the audit, that other factors overcame that presumption. Regarding Issuer B, we have added workpaper documentation to enhance our analysis of this complex issue. However, we continue to believe that the recoupable fees should be recognized ratably over the term of the agreement, as required by the applicable accounting literature. Both issuers intend to resolve these matters with the staff of the SEC.

We have taken action, as appropriate, on each of the other matters described in Part I of the draft Report. In that regard, we have considered whether it was necessary to perform additional procedures in accordance with 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*. As a result, we either enhanced our documentation in the workpapers or performed some additional procedures. However, no new facts came to our attention that caused us to believe that our previously issued reports should be withdrawn.

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

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PCAOB
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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