



1666 K Street, N.W.  
Washington, DC 20006  
Telephone: (202) 207-9100  
Facsimile: (202) 862-8430  
[www.pcaobus.org](http://www.pcaobus.org)

**Report on**  
**2006 Inspection of BDO Seidman, LLP**

**Issued by the**  
**Public Company Accounting Oversight Board**

**May 16, 2007**

**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. 104-2007-065

**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 2006, the Board's inspection process focused on how efficiently the annually inspected U.S. firms performed audits in the second year of implementation 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"). As described in Appendix B to this report, the inspection process occurred at three levels: (1) meetings with senior firm leadership, (2) national office inspection procedures, and (3) inspection procedures for audits of accelerated filers. In general, the Board's inspection teams observed that the firms achieved increased efficiencies as compared to the first year of implementation of AS No. 2. Nonetheless, the Board's inspection teams believed that, in many of these engagements, there were additional opportunities for the auditors to achieve efficiencies in the implementation of AS No. 2. Those observations have been discussed with the firms, and the Board expects that those discussions are contributing to changes to methodology, additional firm training and guidance, and more rigorous discussions with issuers about ways in which firms and issuers can work together to make audits more efficient.

**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.



## 2006 INSPECTION OF BDO SEIDMAN, LLP

In 2006, 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.<sup>1/</sup>

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.<sup>2/</sup> 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.

---

<sup>1/</sup> 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.

<sup>2/</sup> 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 2006 to December 2006. The inspection team performed field work at the Firm's national offices in New York City and Chicago and at eight 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.<sup>3/</sup> 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 eight 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.<sup>4/</sup> 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.

---

<sup>3/</sup> This focus necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

<sup>4/</sup> 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 most cases, the review of the audit of an accelerated filer included a review of aspects of both the Firm's audit of financial statements and its audit of internal control over financial reporting ("ICFR").

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies.<sup>5/</sup> Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP. 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, *Audit Documentation* ("AS No. 3") provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence.<sup>6/</sup> 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

---

<sup>5/</sup> 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.

<sup>6/</sup> See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

deficiencies to the firm's present ability to support its previously expressed opinions,<sup>7/</sup> 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, and in some instances, 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.<sup>8/</sup>

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. The deficiencies that reached this degree of significance are described below, on an audit-by-audit basis.

#### Issuer A

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

- The issuer recorded a valuation allowance that offset the total amount of its net deferred tax assets, which, under Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes*, is appropriate only if it is more likely than not, in light of all available evidence, both positive and negative, that the net deferred tax assets will not be realized. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had considered all available evidence, both positive and negative, in evaluating the issuer's conclusion that it was more likely than not

---

<sup>7/</sup> See AU 390, *Consideration of Omitted Procedures After the Report Date*, 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), and PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("AS No. 2"), ¶ 197.

<sup>8/</sup> 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.

that the net deferred tax assets would not be realized. For example, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had considered the following:

- The issuer had been profitable in the current fiscal year and each of the two preceding fiscal years;
  - The issuer had used a portion of its net operating loss carryforwards in the current fiscal year and each of the two preceding fiscal years; and
  - The issuer's cash flow projections that were included in the work papers indicated that certain significant businesses acquired by the issuer would generate significant pretax income in the near future.
- The issuer agreed to accept certain intangible assets and contract rights from a customer in satisfaction of certain receivables. The issuer used an outside specialist to estimate the value of the intangible assets and contract rights. The estimated value approximated the net book value of the receivables the customer had owed the issuer. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had obtained an understanding of the methods and assumptions that the specialist had used, nor that it had tested the data that the issuer had provided to the specialist.

#### Issuer B

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

- Most of the issuer's revenue was derived from the sale of products and services in accordance with contractual arrangements that generally were tailored for each specific customer. The accounting method applied by the issuer to individual contracts varied depending upon the relevant contract terms. The Firm selected contracts for testing and summarized the contract terms for each contract selected. There was, however, no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed procedures at the individual contract level to determine whether the issuer had used the correct method to account for each contract in light of the contract's specific terms. In addition, in some of the contracts selected for

testing, the Firm identified the existence of multiple deliverables, but there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested the fair values ascribed to the undelivered multiple elements.

- The issuer recognized service revenues on a cost-to-cost percentage of completion basis under Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* ("SOP No. 81-1"), even though most service transactions are excluded from the scope of SOP No. 81-1. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had adequately assessed the appropriateness of the issuer using a cost-to-cost percentage of completion basis or that it had assessed whether the issuer should be following a proportional performance model using output measures as contemplated by SEC Staff Accounting Bulletin Topic 13.
- For contracts using the percentage of completion method of accounting, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had compared the original estimate of project costs to the actual costs incurred for a sample of contracts that were completed during the year in order to assess the issuer's ability to estimate the total costs to complete.

#### 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 incurred damage as a result of a natural disaster. The accounting for and disclosure of the effects of the disaster involved complex judgments about the nature and extent of the damage, the applicability and limits of insurance coverage, and estimates of the insurance deductible. During the approximately six months between the disaster and the date of the Firm's audit report, the issuer retained an insurance claim consultant to assess the damage and to work with the insurance adjusters, and received significant advances from the insurer. To test certain material elements of the issuer's accounting for and disclosures regarding the disaster, the Firm placed significant reliance on discussions with management without obtaining

corroboration from the insurance claim consultant or reviewing relevant correspondence or other related documentation.

- The issuer disclosed that it recognizes revenue, net of certain sales incentives, in accordance with the Emerging Issues Task Force ("EITF") Issue 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)* ("EITF 01-9"), which requires that sales incentives and points earned in point-loyalty programs be recorded as a reduction of revenue. The Firm's audit of the issuer's sales incentives and revenues was deficient in the following respects:
  - The Firm's audit approach was not designed to test, and did not test, whether sales incentives were appropriately recognized and recorded in accordance with EITF 01-9.<sup>9/</sup>
  - There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had completed planned audit procedures to confirm revenues, or had performed alternative procedures, with respect to one of the issuer's locations that was responsible for approximately 30 percent of the issuer's reported revenues.
- The issuer engaged an outside valuation specialist to appraise the fair value of fixed and intangible assets acquired in a business combination. The Firm failed to obtain, and test the completeness and accuracy of, certain of the data that the issuer provided to the valuation specialist.

#### 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 acquired a mature company ("the target company") through a step acquisition. In the first step, which occurred when the issuer had another auditor, the issuer acquired a 50 percent interest in the target company. A valuation study was not conducted, and the only intangible asset recorded was goodwill, despite the fact that the issuer noted in its Form 10-K that the

---

<sup>9/</sup> In the second quarter of the next year, the issuer reclassified the costs associated with certain sales incentives to contra-revenue from operating expense.

target company's technology and distribution network were attractive elements of the acquisition. Twenty months after the first step, the issuer acquired the remainder of the target company. The issuer obtained a valuation report that supported the allocation of 31 percent of the purchase price for the remainder of the company to identifiable intangible assets consisting of acquired technology, customer relationships, and trade names. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether some portion of the cost of the first step should have been allocated to identifiable intangible assets.

- With respect to the valuation report described above, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested the data and evaluated the assumptions that the issuer had provided to the specialist.
- In connection with the second step of the acquisition described above, the issuer recorded the acquired tangible assets, excluding fixed assets, at the target company's historical net book value. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the historical net book value approximated fair value.
- At the end of 2004, the issuer had a valuation allowance that offset a portion of its deferred tax assets. Despite a history of losses in 2004 and each of the two preceding fiscal years and the fact that the issuer had not achieved its income forecasts in 2004 and the preceding fiscal year, the issuer relied on a financial forecast as the basis for establishing a valuation allowance that did not offset substantially all of its deferred tax assets. During 2005, the issuer increased the valuation allowance so that it substantially offset the deferred tax assets by the end of the year. There was no evidence in the 2004 audit documentation, and no persuasive other evidence, that the Firm had considered all the available evidence, both positive and negative, in its evaluation of the appropriateness of the deferred tax valuation allowance.

#### Issuer E

The issuer's revenue was derived from the sale of three services that were sold both on a stand-alone basis and in a bundled package. When multiple services were bundled, the issuer generally gave a discount to its customers. Although EITF 00-21, *Revenue Arrangements with Multiple Deliverables* ("EITF 00-21") specifies that

discounts on bundled arrangements should be allocated in proportion to the relative fair value of each individual element, the issuer allocated the entire discount to a single element, which was the only element for which revenue was recognized evenly over the contract term. The Firm indicated that the issuer maintained that its methodology had the effect of approximating compliance with EITF 00-21 after giving consideration to other provisions of EITF 00-21 that preclude the recognition of portions of revenue that are contingent upon the delivery of any undelivered services. There was no evidence in the Firm's audit documentation, and no persuasive other evidence, that the Firm had tested the issuer's assertion that its method of revenue recognition approximated the result required by EITF 00-21.

#### Issuer F

The issuer invested in numerous limited partnerships with equity interests ranging from 0.1 percent to 31.8 percent. The issuer's ownership percentage in more than half of these investments was less than three percent. The issuer accounted for all of these investments under the equity method. In the case of limited partnership interests where the ownership interest is so minor that the investor has virtually no influence over the partnership's operations and financial policies, the use of the equity method is inappropriate. With respect to the limited partnerships in which the issuer's ownership percentage was less than three percent, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether the issuer had sufficient influence over the partnerships to use the equity method, particularly given the issuer's inability to obtain accurate financial information from the partnerships on a timely basis.

For certain limited partnership investments, the issuer estimated its investment income based on distributions received during the year. During the second quarter of the succeeding year, upon receipt of the limited partnerships' audited financial statements, the issuer recorded an adjustment for the difference between the actual and estimated investment income. For other limited partnership investments, the issuer recorded its investment income on a lag basis, generally during the second quarter of the succeeding year, again upon receipt of the limited partnerships' audited financial statements. The issuer's audited financial statements did not disclose the mix of accounting practices followed with respect to accounting for investment income from the limited partnership investments, nor did they disclose the magnitude of the adjustments in the second quarter or the amount of annual income that was subject to reporting on a lag basis. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the appropriateness of the issuer's disclosures.

#### Issuer G

The issuer had customer-related intangible assets resulting from a series of acquisitions, all of which were amortized over their estimated useful lives using the straight-line method. GAAP requires that customer-related intangible assets be amortized in a pattern commensurate with the associated revenues.<sup>10/</sup> Despite an indication that these customer-related intangible assets could expire on an accelerated basis, and thus that it may not have been appropriate to amortize them using a straight-line method, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had sufficiently assessed whether the issuer's practice of amortizing its customer-related intangible assets using the straight-line method was consistent with GAAP.

#### Issuer H

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

- In each of four acquisitions consummated during the year, the issuer acquired referral lists (a customer-related intangible asset). The issuer engaged an outside valuation specialist to determine the fair value of these referral lists. The Firm failed to test the percentage of total revenue attributable to the referral lists and the assumed attrition rates that were provided by the issuer and used by the valuation specialist in determining the fair value of the referral lists.
- The issuer chose to amortize the referral lists for the four acquisitions on a straight-line basis, even though the calculations supporting the original valuation contemplated a decline in the number of customer relationships over time. There was no evidence in the audit documentation, and no

---

<sup>10/</sup> SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142") requires that the method of amortizing a customer-list intangible asset reflect the pattern in which the economic benefits of the intangible asset are consumed. In addition, the SEC staff has stated that it believes the benefits from customer relationships tend to dissipate more rapidly in the earlier years after an acquisition and, in those instances, an accelerated method of amortization is the most appropriate way to allocate the cost of the customer relationships to the periods that benefit from them (*Current Accounting and Disclosure Issues* (June 30, 2000)).

persuasive other evidence, that the Firm had considered whether the acquired customer relationships should be subject to accelerated amortization.

#### Issuer I

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

- In connection with its acquisition of an unrelated entity, the issuer engaged an outside specialist to perform a valuation of certain acquired assets, including a customer-list intangible asset. The issuer decided to amortize the customer-list intangible asset on a straight-line basis. The specialist's valuation assumed an attrition rate for the customer list, and thus projected declining revenues related to the list. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated whether straight-line amortization was appropriate, in light of an indication that the annual economic benefits from the customer-list intangible asset would decline over its lifetime.
- The issuer recognized revenues from the sale and installation of products and systems using the percentage of completion method. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested, to a sufficient extent, the issuer's ability to estimate total contract costs, which is critical to the determination of the revenue recognized on a percentage of completion basis.

#### Issuer J

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

- There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had performed revenue cut-off procedures, or other sufficient procedures, as of year end to assess whether revenue was recorded in the proper period.
- The Firm failed to perform substantive audit procedures to test the accuracy and completeness of deferred revenues.

## Issuer K

The issuer completed a large acquisition of a foreign company. The issuer used an outside valuation specialist, which had also participated in providing valuation consultation services in advance of the acquisition, to assist with the determination of the value of the acquired intangible assets and in-process research and development. The valuation results were heavily dependent upon information provided by the acquired company to either the issuer or the valuation specialist. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had made appropriate tests of this information. Instead, the Firm compared the information contained in the specialist's report to information that the specialist had received from the issuer, and relied on the specialist to test that information.

### 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 eight 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) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) 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



PCAOB Release No. 104-2007-065  
Inspection of BDO Seidman, LLP  
May 16, 2007  
Page 13

PART II, PART III, APPENDIX A, AND PORTIONS OF APPENDIX C 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, revenue recognition, intangible assets, impairment, business combinations, inventory, reserves, consideration of fraud, and income taxes. 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 selected engagements, the inspection team reviewed written communications between the Firm and the issuer's audit committee. With respect to these 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 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. Efficiency of Implementation of AS No. 2

The inspection team reviewed aspects of the Firm's approach to the implementation of AS No. 2 in light of the provisions of that standard and related Board statements.<sup>11/</sup> Specifically, inspectors evaluated the Firm's approach to (1) integrating the audit of ICFR with the audit of the financial statements, (2) using a top-down approach to the audit, (3) using a risk-based approach, and (4) using the work of others.

The inspection procedures in this area began with the inspection team, along with senior staff in the Board's Division of Registration and Inspections and Office of the Chief Auditor, meeting with members of the Firm's leadership to hear the Firm's perspective on whether and how it had achieved efficiencies in ICFR audits. The inspection team then reviewed the Firm's methodology, tools, and training to determine if those methodology, tools, and training were designed to effectively achieve appropriate efficiencies. This evaluation was followed by a review of aspects of specific ICFR audits. For each audit of an accelerated filer that was the subject of an engagement review, the inspection team assessed the efficiency of the ICFR audit with respect to at least one of the four aspects identified above. The inspection team then met with members of the Firm's leadership to discuss observations from the specific engagement reviews and to provide other feedback relating to the Firm's methodology, tools, and training. The feedback was provided during the course of the inspection field work to facilitate the Firm's ability to use that feedback in ongoing and future ICFR audits.

---

<sup>11/</sup> See PCAOB Release No. 2005-009, *Policy Statement Regarding Implementation of [AS No. 2]* (May 16, 2005); PCAOB Release No. 2005-023, *Report on the Initial Implementation of [AS No. 2]* (Nov. 30, 2005); see also Staff Questions and Answers, *Auditing Internal Control Over Financial Reporting* (May 16, 2005).

### 3. Review of Eight Functional Areas

The inspection team performed the review of the eight functional areas 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 eight functional areas follows.

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

The inspection team reviewed 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 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 Practices for Consultations

The objective of the inspection procedures in this area was to assess the Firm's compliance with professional requirements regarding consultations on accounting, auditing, and SEC matters. Toward this objective, the inspection team gained an understanding of and evaluated the Firm's policies and procedures relating to its consultation process. The inspection team also reviewed a sample of consultations that occurred during the inspection period to evaluate the effectiveness of the Firm's consultation process, the Firm's compliance with its policies and procedures, whether the conclusions were in accordance with professional standards, and whether the engagement teams acted in accordance with the conclusions.

e. 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 reviews of certain engagements on which 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 engagements, the inspection team reviewed the documentation of the internal inspectors' review, 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 those of the Firm's internal inspectors.

f. 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.

g. 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.

h. 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 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; 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 eight 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 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.<sup>12/</sup>

---

<sup>12/</sup> In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.



**BDO Seidman, LLP**  
Accountants and Consultants

**Response to Part I of the Draft Report**  
**on the 2006 Inspection of**  
**BDO Seidman, LLP**



**BDO Seidman, LLP**  
Accountants and Consultants

330 Madison Avenue  
New York New York 10017  
Telephone: (212) 885-8000  
Fax: (212) 697-1299

March 2, 2007

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 the 2006 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 2006 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 2006, communicated those findings to our audit professionals in training sessions, and provided specific guidance to them on topics related to matters raised during the inspection. Certain aspects of our guidance enhancements were implemented during 2006 and, accordingly, were not reflected in the 2006 results.

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, accounting decisions, 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 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 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 continue to develop additional guidance and training in this area and consider new means of ensuring that all of our audits incorporate robust and thoughtful documentation.

Redacted. Confidential Treatment Request Granted by the Board Pursuant to PCAOB Rule 4007(b).

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.

\* \* \* \* \*



BDO Seidman, LLP  
Accountants and Consultants

Mr. George Diacont, Director  
PCAOB  
Page 3 of 3

We appreciate this opportunity to provide our response to the Board and we look forward to further constructive 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*