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## Deloitte & Touche USA LLP's Third Annual Audit Committee Symposium: Highlights and Insights

Several of the most influential people in the area of corporate governance gathered at Deloitte & Touche USA LLP's annual audit committee symposium to share their insights on a variety of topics relevant to audit committee members. The symposium, "What Audit Committees Need to Know," attracted audit committee members from Fortune 500 companies.

In his opening remarks, Andrew G. McMaster, vice chairman of Deloitte & Touche USA LLP, outlined the objectives of the symposium: to present an update on regulatory and corporate governance issues, to provide an open forum where participants could interact with authorities on these matters, and to allow audit committee members to discuss matters of concern with each other.

Sharon Allen, chairman of Deloitte & Touche USA LLP, provided her perspective on the profession and the regulatory environment. She highlighted the need for a shift from rules-based to principles-based accounting.

**Laws, Leadership, and Values.** This panel discussion addressed the composition and roles of audit committees. Moderated by Stephen Wagner, national managing partner of Deloitte & Touche USA LLP's Center for Corporate Governance, the panel featured David Miller, executive director and assistant adjunct professor of business ethics at the Yale Center for Faith & Culture; Ira Millstein, senior partner at Weil, Gotshal & Manges LLP; and Jeffrey Sonnenfeld, professor and senior associate dean of executive programs at the Yale School of Management.

The panel discussed the qualifications of audit committee members, including financial expertise, character, and principles, concluding that audit committees benefit from a broad range of skills and experience. Panelists noted that there seems to be little correlation between the financial acumen of board members and companies' accounting difficulties. The panel also noted that there is increasing emphasis on character and the need for audit committee members who are willing to ask tough questions of management. The panelists recognized the time demands on audit committee members and agreed that members must be committed to understanding the company's business and finances.

### **Whistleblower and Ethics Programs.**

David Miller and Harold Tinkler, chief ethics and compliance officer of Deloitte & Touche USA LLP, presented a program on the attributes of an ethics officer and how audit committee members can use the ethics officer's position. To highlight the importance of the position, the ethics officer should be a person of stature in the organization who reports directly to the audit committee. This will set a tone that emphasizes the importance of ethics.

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# Audit Committee Symposium: Highlights and Insights *(Continued from page 1)*

Mr. Tinkler and Mr. Miller suggested questions that audit committee members should ask themselves concerning the ethics officer and whistleblower issues:

- Does the audit committee communicate directly with the person who has day-to-day responsibility for helpline activities?
- Is the ethics officer independent of the general counsel's office?
- Does the ethics officer have an adequate budget?
- Does the company scrutinize the sources of compliance failures regularly and systematically and does it react appropriately?
- How does management take action on reports? Are employees at all levels disciplined appropriately and consistently?
- How is the board informed of ethics issues and the actions taken to address them? Is ethics and compliance a regular board agenda item?
- What types of processes are in place to assess the effectiveness of the program? Are the code of ethics and the compliance program reviewed at least annually? Has the program been reviewed by outside consultants for possible improvement?

**Highlights from the Second Day.** The second day's opening remarks were provided by James H. Quigley, chief executive officer of Deloitte & Touche USA LLP, who acknowledged that the past five years have been tumultuous in the accounting profession. He said the new corporate governance model requires company management and audit committees to determine how to balance the power between the c-suite and the board.

"I believe we're in a better place than we were five years ago. And I believe the model that we have is better than the model that we lived with for the 70 years that preceded it," he said.

**Regulatory Update.** Robert J. Kueppers, deputy chief executive officer of Deloitte & Touche USA LLP, discussed developments related to Section 404 of the Sarbanes-Oxley Act. Mr. Kueppers then discussed various efforts related to regulation of the capital markets, including Treasury Secretary Henry Paulson's conference on the capital

markets and economic competitiveness in early 2007. The conference focused on three primary areas: the U.S. legal system, the U.S. regulatory structure, and the U.S. accounting system.

Recommendations of the interim report of the Committee on Capital Markets Regulation were also discussed. The report comprised 32 recommendations in areas such as competitiveness, reform of the regulatory process, the private and public enforcement system, shareholder rights, and Section 404 of the Sarbanes-Oxley Act.

## Perspectives on the Audit Committee

**Role.** William J. McDonough, former chairman of the PCAOB and vice chairman and special advisor to the chairman of Merrill Lynch & Co., Inc., offered his perspective on the role of the audit committee.

In addition to fulfilling the responsibilities outlined in the charter, Mr. McDonough indicated that proactive audit committees:

- Review new and proposed accounting rules
- Review the impact on earnings of potential accounting changes
- Keep abreast of the global regulatory environment
- Get updates on legal matters that may have a significant effect on the company's earnings or reputation
- Seek out information regarding trends in the industry.

Mr. McDonough outlined the characteristics of the best-in-class audit committees. They do what proactive audit committees do, plus they:

- Obtain business updates to review and understand internal controls and conflicts
- Monitor both organic and inorganic company growth to determine whether new businesses are being integrated in a controlled manner
- Monitor the company's infrastructure and back office to determine whether they are adequate and keeping pace with the business
- Attend business strategy sessions



- Communicate with management between audit committee meetings
- Attend management-sponsored training sessions, including new director orientation
- Engage in ongoing dialogue with the auditor
- Gain a deeper understanding of relevant accounting policies and attend training on those policies.

Mr. McDonough also noted several red flags for audit committee members. Internally, these include slow resolution of issues, a lack of participation in important matters by segments of the business, negative trends in operating results, and litigation and fines. External red flags include matters garnering industrywide regulatory focus, issues experienced by competitors, and media scrutiny.

## Making the Grade: A Look at Corporate Governance Ratings.

William Ezzell, managing partner of government relations at Deloitte & Touche USA LLP, moderated a discussion on corporate governance ratings with panelists Pat McGurn, executive vice president and special counsel at Institutional Shareholder Services; Howard Sherman, chief operating officer of GovernanceMetrics International; and Lynn Turner, managing director of research at Glass, Lewis & Co.

The panelists discussed the details of how they rate companies and noted that they believe the focus on ratings will become more significant over time. They discussed

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## Audit Committee Symposium: Highlights and Insights *(Continued from page 2)*

various metrics they consider, including the number of boards on which a director serves, compensation disclosures, and director term limits.

The panelists provided perspectives on the use of public information to derive their findings, indicating that certain studies have linked better corporate governance to lower costs of capital. They also noted that companies are placing a premium on corporate governance.

### Special Investigations: Audit Committee Oversight and Involvement.

Irwin Warren, partner and co-head of the securities litigation/corporate governance practice at Weil, Gotshal & Manges LLP,

discussed audit committee oversight and involvement in the context of special investigations. He noted that:

- Audit committee members should ask themselves whether they are prepared, at the direction of prosecutorial authorities seeking “cooperation,” to take action against employees who have not been proven to engage in wrongdoing if the alternative is that the government will indict the company.
- Audit committees should set up lines of communication with the external auditors early and be proactive in dealing with them.
- Audit committees’ counsel should communicate with regulators regularly during the

course of an investigation, even if there are no open issues. Do not favor one regulator over another.

- The fiduciary duties of directors include:
  - **Duty of care** – make decisions after gathering and considering all relevant evidence that is reasonably obtainable
  - **Duty of loyalty** – act in the best interest of the company and its shareholders, not in personal interest or the interests of management
  - **Duty of candor** – the best investigation and oversight will not do any good if there is a reasonable perception that it was biased or less than candid. ●

## Recent SEC and PCAOB Developments Related to Section 404

The SEC’s proposed guidance for management’s annual assessment of ICFR is described as principles-based and applies to all registrants. The proposed guidance is intended to be scalable, flexible, and based on a top-down, risk-based approach. The proposal stresses the exercise of management’s judgment and provides guidance in four main areas:

- Identification of risks to reliable financial reporting and related controls
- Evaluation of the operating effectiveness of controls
- Reporting the overall results of management’s evaluation
- Documentation.

Underpinning the proposed guidance is management’s selection of a recognized framework, such as COSO, as the basis for the company’s assessment. Highlights of the proposed interpretive guidance include:

- Management’s objective should be to identify only those controls necessary to adequately address material misstatement.
- Management should consider all locations in assessing risks.
- Management’s assessment must be supported by evidential matter that provides reasonable support for its conclusion.

	Accelerated Filer Status	Compliance Dates for Internal Control over Financial Reporting Requirements	
		Management’s Report	Auditor’s Attestation
U.S. Issuer	Large Accelerated Filer or Accelerated Filer (\$75MM or more)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)
	Nonaccelerated Filer (less than \$75MM)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
Foreign Issuer	Large Accelerated Filer (\$700MM or more)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer (\$75MM or more and less than \$700MM)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Nonaccelerated Filer (less than \$75MM)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
U.S. or Foreign	Newly Public Company	Second annual report	Second annual report

- The form and extent of documentation required to support the assessment will vary based on the size, nature, and complexity of the company.
- Management’s evaluation of deficiencies should be based on both quantitative and qualitative factors.
- Management and the auditor can have different testing approaches.

The SEC’s proposal also requires that the auditor opine only on the effectiveness of ICFR, and eliminates the separate opinion on management’s assessment.

The SEC extended Section 404 compliance dates for both nonaccelerated filers and newly public companies. The accompanying table sets forth the compliance dates for all issuers.

### PCAOB Proposed Auditing Standards.

The PCAOB proposed two auditing standards: 1) *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements*, which would supersede Auditing Standard No. 2, and 2) a related auditing standard, *Considering and Using the Work of Others in an Audit*. The PCAOB indicates that the proposed standards are intended to achieve four objectives:

*(Continued on page 4)*

## Recent SEC and PCAOB Developments Related to Section 404 *(Continued from page 3)*

- Focus the audit on the matters most important to ICFR
- Eliminate unnecessary procedures
- Facilitate scaling in audits of smaller companies
- Simplify the requirements.

The PCAOB's proposal incorporates guidance issued in May 2005 and previously issued *Staff Questions and Answers* relating to Auditing Standard No. 2. Like the May 2005 guidance, the proposed standard emphasizes the use of a top-down, risk-based approach. Although the fundamental principles remain unaltered, there are some changes, including:

- Eliminating the requirement for the auditor to report on management's ICFR

assessment (however, the auditor is still required to understand management's process for assessing ICFR)

- Clarifying that the ICFR and financial statement audits should be planned and performed using the same measures of materiality
- Eliminating the requirement that the selection of locations for multilocation testing should cover a large portion and introducing a risk-based approach to determine the appropriate strategy
- Recalibrating the walk-through process to focus on each significant process, rather than on each major class of transactions.

The PCAOB's proposed standard, *Considering and Using the Work of Others in an*

*Audit*, will allow the auditor to use the work of others, beyond the internal audit staff, if they are determined to be objective and competent.

**More Information.** The full text of the SEC's releases is available at <http://www.sec.gov/rules/proposed/2006/33-8762.pdf> and <http://www.sec.gov/rules/final/2006/33-8760.pdf>. The full text of the PCAOB proposals is available at [http://www.pcaobus.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf). Deloitte & Touche hosted a webcast entitled "Section 404: What Do the Proposed Changes Mean to You." It is archived at [http://www.deloitte.com/dtt/section\\_node/0%2C1042%2Csid%25253D58770%2C00.html#SO](http://www.deloitte.com/dtt/section_node/0%2C1042%2Csid%25253D58770%2C00.html#SO).

### Questions the Audit Committee Might Ask Concerning the Section 404 Proposals

- Has management evaluated the impact of the SEC's proposal?
- How is management evaluating risk and are changes needed for lower-risk areas?
- Has management undertaken a controls rationalization process? Is additional rationalization necessary to focus on the highest-risk areas?
- How is management planning to test and document controls?
- Are there opportunities for the auditor to rescope work?
- Has the auditor coordinated efforts with management's plans to implement the SEC guidance? •



## Update to SFAS 157, *Fair Value Measurements*

FASB Statement No. 157 (SFAS 157), *Fair Value Measurements*, released in the fall of 2006, focuses on the definition of fair value and related measurement guidance. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

SFAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants."

For more information, see Deloitte & Touche's September 27, 2006, edition of *Heads Up* at <https://www.auditcommittee.com/USEng/topics/contentItem.asp?topic=37&subject=159>. The statement is available at <http://www.fasb.org/pdf/fas157.pdf>. •

## SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, was released in February 2007 and expands the scope of what companies may carry at fair value. SFAS 159 offers an irrevocable option to carry the majority of financial assets and liabilities at fair value, with changes in fair value recorded in earnings. The statement is effective for financial statements issued for fiscal years

beginning after November 15, 2007. Under certain circumstances, earlier application is permitted.

For details of SFAS 159, see Deloitte & Touche's February 22, 2007, edition of *Heads Up* at <https://www.auditcommittee.com/USEng/topics/contentItem.asp?topic=37&subject=159>. The statement is available at <http://www.fasb.org/pdf/fas159.pdf>. •

## What's New on Audit Committee Online

Audit Committee Online is an easy-to-use resource for understanding and addressing key issues in corporate governance.

***Some Thoughts for Boards of Directors in 2007*** – Senior partner Martin Lipton from the law firm of Wachtell, Lipton, Rosen & Katz provides insight into the major governance issues likely to confront organizations in 2007.

***Addressing Auditor/Client Disputes in Engagement Letters: Cause for Concern or Much Ado about Nothing?*** – This *Directors Monthly* article outlines steps directors might take with respect to audit engagement letters.

***2006 Corporate Governance and Compliance Hotline Benchmarking Report*** – The Network, CSO Executive Council, and the Association of Certified Fraud Examiners provide a comprehensive examination of organizational hotline activity.

***Seven Things Shareholders Want Directors to Understand in 2007*** – This Weil, Gotshal & Manges LLP article provides their observations on shareholders' expectations and the concerns of boards this year.

***Cornerstone of the Board: Opening the Board's Window on the World*** – This Spencer Stuart survey examines the importance of adding an international perspective to U.S. boards and what they need to consider when adding international representation to them.

***AICPA National Conference on SEC and PCAOB Developments*** – A summary of key issues addressed at the conference, along with links to the speeches, is available in Deloitte & Touche's December 21, 2006, edition of *Heads Up* on the "Deloitte Periodicals" page of Audit Committee Online.

To access these and other resources on Audit Committee Online, visit [www.audit-committee.com](http://www.audit-committee.com). If you would like to register for the site, e-mail us at [audit-committee@deloitte.com](mailto:audit-committee@deloitte.com).

**Coming Soon: *The Center for Corporate Governance – Beyond Compliance***. In the spring of 2007, Audit Committee Online will expand its content to include general corporate governance matters beyond the audit committee and compliance requirements. Boards of directors, c-suite executives, investors, and other constituents will soon have additional resources to help them understand issues and identify solutions when Deloitte & Touche USA LLP launches its Center for Corporate Governance. ●



## Dbrief Webcasts

Dbrief webcasts feature Deloitte & Touche and other professionals discussing issues affecting many companies. Designed for executives, Dbriefs are 60- to 90-minute live sessions that are archived for replays. Continuing professional education credit is available for most Dbriefs. Below is a list of Dbriefs on SFAS 157 and other relevant topics.

- *Replay of The FASB Statement on the Fair Value Option: Overview of the Standard* – <https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=404&eventid=39732&sessionid=1&key=490B201C37E7C0B058A4960791213390>
- *Corporate Governance: Corporate Social Responsibility – Trends, Challenges, and Potential Benefits* (April 4, 2007, 2:00–3:00 pm EDT)
- *Diversifying the American Board: Considerations for Joining a Board of Directors* (May 2, 2007, 2:00–3:00 pm EDT)
- *The Latest Trends in Corporate Governance* (June 20, 2007, 2:00–3:00pm EDT)

For a complete list of upcoming Dbriefs and to register to participate, please visit <http://www.deloitte.com/us/dbriefs>. ●

## Modification to Executive Compensation Rules

Recently, the SEC amended the executive compensation and disclosure rules that are effective for 2006 Form 10-Ks and proxy statements filed after December 15, 2006. The amendments change the amount of compensation for stock-option grants reported in the summary compensation table for executive officers and the director compensation table for directors.

The interim final rules are available at <http://www.sec.gov/rules/final/2006/33-8765.pdf>. Also see Deloitte & Touche's January 8, 2007, edition of *Heads Up* at the Deloitte Periodicals page of Audit Committee Online for more information. ●

The purpose of this publication is to briefly describe current key regulatory, technical, and professional developments in the corporate governance and accounting fields, and to provide links to additional information. Readers seeking a more in-depth analysis of a topic should review the information referenced in the hyperlinks and not rely on the descriptions included in this communication.

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# Regulatory Highlights and Outlook

The following are highlights of recent regulatory developments:

## SEC:

*December 13, 2006* – The SEC approves proposed interpretive guidance for management related to its evaluation of ICFR as required by Section 404 of the Sarbanes-Oxley Act.

*December 13, 2006* – The SEC votes to repropose amendments to the rules that govern the circumstances under which a foreign private issuer may deregister. Additional information is available at <http://www.sec.gov/news/press/2006/2006-207.htm>.

*December 15, 2006* – The SEC extends the Section 404 compliance dates for both domestic and foreign private issuers, nonaccelerated filers, as well as newly public companies.

*December 22, 2006* – The SEC adopts an amendment to its recent executive and director compensation disclosure rules to facilitate disclosures that are more closely aligned with the reporting of stock and option awards under SFAS 123, as revised in 2004.

*February 5, 2007* – The SEC names James Kroeker deputy chief accountant. Mr. Kroeker was formerly a partner with Deloitte & Touche.

*February 26, 2007* – The comment period closes for proposed interpretive guidance for management related to its evaluation of ICFR as required by Section 404 of the Sarbanes-Oxley Act.

*March 6, 2007* – The SEC holds a roundtable discussion on the “roadmap” regarding International Financial Reporting Standards (IFRS). The roadmap, first described in April 2005, outlines the

path to eliminating the need for non-U.S. companies to reconcile IFRS-based financial statements filed with the SEC to U.S. GAAP financial statements.

*March 19, 2007* – The SEC holds a roundtable on the use of interactive data by public companies and mutual funds to improve disclosure for individual investors. This is the third roundtable in the SEC’s series on this topic.

## PCAOB:

*December 19, 2006* – The PCAOB proposes two new auditing standards, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements* and *Considering and Using the Work of Others in an Audit*, as well as related proposals.

*January 3, 2007* – The PCAOB announces the continuation of its Forums on Auditing in the Small Business Environment, which help share information concerning the PCAOB with registered public accounting firms and public companies operating in the small-business community.

*January 22, 2007* – The PCAOB issues a report on auditor implementation of the PCAOB’s interim standards related to the auditor’s responsibility with respect to fraud. The report is available at [http://www.pcaobus.org/Inspections/Other/2007/01-22\\_Release\\_2007-001.pdf](http://www.pcaobus.org/Inspections/Other/2007/01-22_Release_2007-001.pdf).

*January 24, 2007* – The PCAOB announces that J. Gordon Seymour, deputy general counsel of the PCAOB, will succeed Lewis H. Ferguson III as general counsel.

*February 26, 2007* – The comment period closes for the two proposed auditing standards released on December 19, 2006.

*March 6, 2007* – PCAOB Chairman Mark W. Olson and European Union Commissioner Charlie McCreevy discuss steps to enhance cooperation between the PCAOB and European auditor oversight bodies and to advance collaborative efforts in 2007. Additional information is available at [http://www.pcaobus.org/News\\_and\\_Events/News/2007/03-06.aspx](http://www.pcaobus.org/News_and_Events/News/2007/03-06.aspx).

## Other Developments:

*January 30, 2007* – The American Institute of Certified Public Accountants and eight public-company auditing firms announce the formation of the Center for Audit Quality to aid investors and issuers in a time of growing financial complexity and market globalization. The CAQ will work to increase confidence in the audit process and make public-company audits more reliable and relevant by advancing suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust. Additional information is available at [www.thecaq.org](http://www.thecaq.org).

*March 13, 2007* – U.S. Treasury Secretary Henry M. Paulson hosts a conference to examine issues affecting U.S. capital markets’ competitiveness. The conference focused on three areas: regulatory structure, the accounting industry, and the legal and corporate governance environment. Additional information is available at <http://www.treasury.gov/>.

*March 14, 2007* – The U.S. Chamber of Commerce hosts Capital Markets Summit: Securing America’s Competitiveness. The report and recommendations of the U.S. Chamber of Commerce’s Commission on the Regulation of U.S. Capital Markets in the 21st Century is released in conjunction with the summit. ●

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