
ORDER INSTITUTING DISCIPLINARY
PROCEEDINGS, MAKING FINDINGS, AND
IMPOSING SANCTIONS

*In the Matter of Clyde Bailey, P.C., and
Clyde B. Bailey, CPA,*

Respondents.

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) PCAOB Release No. 2005-021
) PCAOB No. 105-2005-003
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) November 22, 2005
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Summary

By this Order, the Public Company Accounting Oversight Board ("Board" or "PCAOB") is revoking the registration of Clyde Bailey, P.C, and barring its sole shareholder, Clyde B. Bailey, CPA, from being an associated person of a registered public accounting firm. The Board is imposing these sanctions on the basis of its findings concerning the respondents' violations of PCAOB rules and auditing standards in auditing the financial statements of four issuer clients during 2004 and 2005.

I.

The Board deems it necessary and appropriate, for the protection of investors and to further the public interest in the preparation of informative, fair, and independent audit reports, that disciplinary proceedings be, and hereby are, instituted pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 5200(a)(1) against Clyde Bailey, P.C., ("CBPC") and Clyde B. Bailey, CPA ("Bailey") (collectively, "Respondents").

II.

In anticipation of institution of these proceedings, and pursuant to PCAOB Rule 5205, CBPC and Bailey have each submitted an Offer of Settlement ("Offers") that the Board has determined to accept. Solely for purposes of this proceeding and any other proceedings brought by or on behalf of the Board, or to which the Board is a party, and without admitting or denying the findings herein, except as to the Board's jurisdiction over them and the subject matter of these proceedings, which is admitted, the Respondents

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each consent to entry of this Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions ("Order") as set forth below.

III.

On the basis of Respondents' Offers and information obtained by the Board in this matter, the Board finds^{1/} that:

A. Respondents

1. CBPC is an accounting firm incorporated in the state of Texas and licensed by the Texas State Board of Accountancy (license no. C02330). CBPC is registered with the Board pursuant to Section 102 of the Act and PCAOB Rules. Its only office is located in San Antonio, Texas.

2. Bailey, 50, of San Antonio, Texas, is a certified public accountant licensed by the state of Texas (license no. 023975). He has been the principal shareholder of CBPC since 1990. Bailey is an associated person of CBPC, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i).

B. Respondents Violated PCAOB Auditing Standards

3. An auditor may express an unqualified opinion on an issuer's financial statements only when the auditor has formed such an opinion on the basis of an audit performed in accordance PCAOB standards.^{2/} Among other things, those standards require that an auditor exercise due professional care, exercise professional skepticism, and obtain sufficient competent evidential matter to afford a reasonable basis for an

^{1/} The findings herein are made pursuant to the Respondents' Offers and are not binding on any other person or entity in this or any other proceeding. The sanctions that the Board is imposing in this Order may be imposed only if a respondent's conduct meets one of the conditions set out in Section 105(c)(5) of the Act, 15 U.S.C. § 7215(c)(5). The Board finds that Respondents' conduct described in this Order meets the condition set out in Section 105(c)(5)(A), which provides that such sanctions may be imposed in the event of "intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard."

^{2/} See AU § 508.07, *Reports on Audited Financial Statements*.

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opinion regarding the financial statements.^{3/} In connection with their audits of the fiscal year ("FY") 2003 financial statements of four issuer clients, Respondents failed to exercise due professional care, failed to exercise professional skepticism, and failed to obtain sufficient competent evidential matter. Specific instances of Respondents' conduct constituting violations of PCAOB standards are described below.

1. FY 2003 Audit of Endeveco, Inc.

4. Endeveco, Inc. ("Endeveco") (formerly Adair International Oil and Gas, Inc.) is a Texas corporation with offices in Houston, Texas. Its common stock is registered with the United States Securities and Exchange Commission ("Commission") under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and is dually quoted on the OTC Bulletin Board and the Pink Sheets. Endeveco's public filings disclose that it is pursuing, among other things, oil and gas exploration and development opportunities in the United States and Colombia. Endeveco is an issuer, as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

5. CBPC was engaged as Endeveco's independent auditor from March 2003 through July 2005. On January 26, 2004, CBPC issued an unqualified audit report on Endeveco's consolidated financial statements for the year ended December 31, 2003.^{4/} The report stated that the company's financial statements fairly presented its financial condition in all material respects in conformity with U.S. generally accepted accounting principles ("GAAP").^{5/} CBPC's audit report was included in the Form 10-KSB filed by Endeveco with the Commission on March 31, 2004.

^{3/} See AU § 150.02, *Generally Accepted Auditing Standards*; § 230, *Due Professional Care in the Performance of Work*; § 326, *Evidential Matter*.

^{4/} The audit report included an explanatory paragraph expressing substantial doubt as to Endeveco's ability to continue as a going concern.

^{5/} CBPC's audit reports for Endeveco, Call Now, Inc., and Image Innovations Holdings, Inc. stated that its audits were conducted in accordance with U.S. generally accepted auditing standards ("GAAS"). Respondents were required to conduct those audits in accordance with the PCAOB's interim auditing standards pursuant to PCAOB Rule 3200T, which took effect on April 25, 2003. However, at the time those audits were performed, the PCAOB's interim auditing standards were the same as GAAS as it existed on April 16, 2003, and, until PCAOB Auditing Standard No. 1 took effect on May

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a. Valuation of Options to Acquire Leasehold Interests

6. During FY 2003, Endevco disclosed that it acquired two options to acquire interests in certain oil and gas leasehold interests in Colombia and the Gulf of Mexico. The company stated that it acquired the options in exchange for a \$500,000 note and 1.5 million shares of preferred stock valued at \$1.00 per share. Endevco recorded those options as assets (characterized as "oil and gas properties and equipment under full cost method") valued at \$2,000,000, representing 61 percent of the company's total reported assets at December 31, 2003. Other than obtaining the option agreements and reviewing the Board resolution authorizing the option purchases, Respondents performed no audit procedures to assess the values assigned by management to the option rights or to the preferred shares that were exchanged for those rights.

7. Moreover, other than relying on management's assurances, Respondents performed no audit procedures to test whether the option rights would result in a probable future economic benefit to Endevco.^{6/} Respondents failed to perform such procedures despite the existence of several factors that cast doubt on Endevco's ability to exercise the options. As set forth in the option agreements included in Respondents' work papers, each option was exercisable by Endevco until June 30, 2005, at an exercise price of \$2 million per option. That \$4 million total exercise price, however, exceeded Endevco's total reported assets at year end 2003. In addition, even if Endevco had exercised the options, the company would have been obligated to execute a purchase agreement warranting that the company had a minimum of \$5 million in current and unencumbered assets. At December 31, 2003, however, Endevco's balance sheet reflected current assets totaling only 11 percent of the required \$5 million, and the company had not generated operating income for at least the preceding eight years. Finally, in prior periods, Endevco had written off assets associated with similar option contracts due to either non-performance or expiration of the option agreements.

24, 2004, it remained appropriate for auditors to refer to GAAS in their audit reports. Accordingly, while the references to GAAS in CBPC's reports for the aforementioned issuers were appropriate at the time, the standards pursuant to which those audits were required to be performed are more appropriately referred to as PCAOB auditing standards (or PCAOB standards), and that is how they are referred to in this Order.

^{6/} See FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 25 (asset defined as a "probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events").

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8. In the face of these "red flags" concerning Endevco's ability to exercise the options, Respondents relied exclusively on management's assurances that the company would be able to obtain from unidentified sources the funds needed for the exercise price and that the option sellers would waive the \$5 million current asset requirement if the exercise price were paid. PCAOB standards provide that "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."^{7/} Respondents violated PCAOB standards by relying solely on representations made by Endevco's management and failing to perform other audit procedures sufficient to evaluate those representations.

b. Revenue Recognition

9. Endevco's consolidated financial statements reported that revenues increased from \$2,286 in FY 2002 to \$1,513,419 in FY 2003. Most of that increase related to a contract that, according to Endevco, provided for initial funding of \$2 million to conduct a certain feasibility study. As of year end 2003, Endevco had recorded as received, and had recognized as revenue, approximately 75 percent of the initial funding.^{8/} Endevco also recorded a subcontract cost in that same amount because, according to Endevco, it had entered into a fixed-price agreement with a consulting firm to have the consulting firm perform the feasibility study, and it had paid the consulting firm an amount equal to what Endevco had received (\$1,496,500) on the contract.

10. Respondents failed to perform necessary audit procedures to evaluate whether it was appropriate for Endevco to recognize the recorded receipts under the contract as revenue in FY 2003. Respondents did not evaluate whether Endevco had earned the amounts recognized and did not evaluate whether the amounts met the revenue recognition criteria set forth in GAAP.^{9/} In fact, Respondents ignored evidence suggesting that revenue recognition may not have been appropriate. Specifically,

^{7/} AU § 333.02, *Management Representations*.

^{8/} Endevco recorded a receivable for the remaining 25 percent and deferred recognition of such revenue.

^{9/} SEC Staff Accounting Bulletin No. 101, *Revenue Recognition* ("SAB 101"), sets out relevant principles relating to revenue recognition.

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Respondents were aware that the feasibility study was not completed in FY 2003, and the contract made no provision for payment for partial performance, which are relevant factors in assessing the appropriateness of recognizing the revenue.

c. Related Party Transactions

11. Respondents failed to perform necessary audit procedures to evaluate whether Endevo had engaged in material related party transactions during FY 2003. In fact, Respondents ignored evidence in the work papers indicating that such transactions may have occurred.

12. Specifically, documents contained in Respondents' work papers identified one individual who served as president of four entities that had significant business relationships with Endevo during FY 2003, including the two entities that purportedly sold Endevo the leasehold options valued at \$2 million on Endevo's balance sheet, the consulting firm to which Endevo purportedly subcontracted the contract feasibility study and to which Endevo purportedly paid \$1,496,500, and a fourth entity to which Endevo issued 529,904 shares of preferred stock and that may thereby have effectively obtained voting control of the company.^{10/} In addition, a schedule contained in Respondents' work papers indicated that the consulting firm controlled by this individual directly paid more than \$180,000 of Endevo's operating expenses in FY 2003 (including more than \$23,000 in audit-related fees paid to CBPC) and received preferred shares as repayment. The name of the expense-paying entity identified on the schedule was a truncated version of the consulting firm's full name. Respondents, however, performed no audit procedures to determine whether the entity identified on the schedule was the same as the consulting firm performing the feasibility study, beyond asking a member of Endevo's management and being told that they were not the same.

^{10/} Endevo issued the preferred stock to that entity purportedly in return for the entity having directly paid certain Endevo operating expenses totaling \$529,904. As disclosed in the notes to Endevo's financial statements, each share of Endevo's preferred stock was convertible into 1,000 shares of the company's common stock, and the preferred shares carried voting rights on an as-converted basis with the common stock. Thus, the 529,904 preferred shares held by the entity had voting rights equivalent to 529,904,000 common shares. With 150,000,000 shares of Endevo common stock issued and outstanding as of December 31, 2003, the information in Respondents' work papers should have indicated to Respondents that that entity's holdings of preferred stock may have given it voting control of the company.

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13. Documents evidencing the same individual's apparent involvement in the management of four entities having significant business relationships with Endevco, one of which may have had voting control of the company, should have caused Respondents to perform audit procedures to test whether Endevco's purchase of the leasehold options and its contract with the consulting firm constituted material related party transactions requiring disclosure under GAAP.^{11/} Instead, Respondents ignored these "red flags," and in doing so, violated PCAOB standards requiring them to exercise due professional care and professional skepticism in their performance of the Endevco audit.

2. FY 2003 Audit of Call Now, Inc.

14. Call Now, Inc. ("Call Now") (formerly Phone One International, Inc.) is a Nevada corporation with offices in Selma, Texas. Its common stock is registered with the Commission under Section 12(g) of the Exchange Act and is quoted on the Pink Sheets. Call Now's public filings disclose that its primary operation is the management, through an 80 percent owned subsidiary, of the Retama Horse Racing Facility in Selma, Texas. Call Now is an issuer, as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

15. CBPC was engaged as Call Now's independent auditor from approximately 1998 through April 2005. On March 10, 2004, CBPC issued an unqualified audit report on Call Now's consolidated financial statements for the year ended December 31, 2003. The report stated that the company's financial statements fairly presented its financial condition in all material respects in conformity with GAAP. CBPC's audit report was included in the Form 10-KSB filed by Call Now with the Commission on March 31, 2004.

16. Call Now reported that it held marketable securities valued at \$5,407,565, representing nearly 40 percent of total recorded assets at December 31, 2003. Respondents failed to perform audit procedures necessary to assess the valuation of those securities.

17. For example, one security (representing 81 percent of the total reported value of Call Now's marketable securities) was valued by management at an amount substantially less than the value reflected in a brokerage statement issued by the

^{11/} Statement of Financial Accounting Standards ("SFAS") No. 57, *Related Party Disclosures*, requires, among other things, that financial statements include disclosures of certain material related party transactions.

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company's investment firm. While the investment firm priced that security (a bond issue) at \$0.235 per unit, Call Now's management verbally informed Respondents that the appropriate price was \$0.10 per unit. As a result of management's reduced valuation, Call Now reported the value of its holdings in that security as \$4,396,250, rather than the \$10,331,187.50 shown in the brokerage statement. Respondents accepted management's reduced valuation at face value without performing additional procedures necessary to test whether the valuation was appropriate.

3. FY 2003 Audit of Image Innovations Holdings, Inc.

18. Image Innovations Holdings, Inc. ("Image") (formerly Busanda Explorations, Inc.) is a Nevada corporation with a mailing address in New York, New York. Its common stock is registered with the Commission under Section 12(g) of the Exchange Act and is dually quoted on the OTC Bulletin Board and the Pink Sheets. Image's public filings disclose that it has facilities in New York and British Columbia, Canada, and that it is in the business of promotional licensing and branding of low-cost products. Image is an issuer, as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

19. CBPC was engaged as Image's independent auditor from January 2003 to January 2005. On March 10, 2004, CBPC issued an unqualified audit report on Image's consolidated financial statements for the year ended December 31, 2003. The report stated that the company's financial statements fairly presented its financial condition in all material respects in conformity with GAAP. CBPC's audit report was included in the Form 10-KSB filed by Image with the Commission on April 14, 2004.

20. Although CBPC was engaged as Image's independent auditor at the time, the company separately engaged another audit firm to perform audit procedures on its FY 2003 consolidated financial statements. While the other firm did not issue an audit opinion, it provided copies of its work papers to CBPC for its review and acknowledged its understanding that CBPC intended to rely on its work as a component of its audit procedures. The audit evidence obtained through procedures performed by the other firm constituted substantially all of the audit evidence obtained to support CBPC's audit opinion.

21. The level of planning, testing, supervision, and review exercised by Respondents with regard to the other auditors' work was not sufficient to enable CBPC to use the work of the other auditor in the same manner as if it had been performed by

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CBPC's own personnel.^{12/} As a result, Respondents violated PCAOB standards in issuing an audit report on Image's FY 2003 consolidated financial statements.

4. FY 2003 Audit of Health Discovery Corporation

22. Health Discovery Corporation ("Health Discovery") (formerly Direct Wireless Communications, Inc.) is a Texas corporation with offices in Lorena, Texas and Savannah, Georgia. Health Discovery is required to file reports under Section 15(d) of the Exchange Act and its stock is dually quoted on the OTC Bulletin Board and the Pink Sheets. Health Discovery's public filings disclose that it is in the business of developing a product line of newly discovered biomarkers and pathways to assist pharmaceutical and diagnostic companies. Health Discovery is an issuer, as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

23. On January 5, 2005, CBPC issued an unqualified audit report on the financial statements of Health Discovery for the year ended December 31, 2003.^{13/} The report stated that CBPC had conducted an audit of those statements in accordance with PCAOB standards. The report also stated that Health Discovery's financial statements fairly presented its financial condition in all material respects in conformity with GAAP. CBPC's audit report was included in the Form 10-KSB/A filed by Health Discovery with the Commission on January 7, 2005.

24. CBPC was the second audit firm to report on Health Discovery's FY 2003 financial statements. The first audit firm (the "prior auditor") issued a report on those statements on February 27, 2004.^{14/} As Health Discovery learned several months later, however, its prior auditor had never registered with the PCAOB as required by Section 102 of the Act. On December 15, 2004, Health Discovery filed a Form 8-K reporting that it had been notified by NASDAQ of the prior auditor's non-registered status. The company disclosed that, as a result, it was not in compliance with NASDAQ listing standards.

^{12/} See AU § 230 and AU § 311, *Planning and Supervision*.

^{13/} The audit report included an explanatory paragraph expressing substantial doubt as to Health Discovery's ability to continue as a going concern.

^{14/} The prior auditor's report was included in the Form 10-KSB filed by Health Discovery on March 30, 2004.

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25. Although Health Discovery engaged a new independent auditor in August 2004,^{15/} the company did not use the new auditor to reaudit its FY 2003 financial statements. Instead, Health Discovery's prior auditor arranged for CBPC to issue a new FY 2003 audit report. One of the prior auditor's principals was a long-time business acquaintance of Bailey, and, during the last week of December 2004, he asked whether Bailey would review his work papers and issue a revised report on Health Discovery. Bailey agreed to do so, even though, according to Bailey, Health Discovery never paid him for the work. Bailey viewed the arrangement in terms of a barter transaction with the prior auditor, and testified that "I did this work for him and he's done some work for me . . . I felt it was more of a trade"

26. Where an auditor accepts an engagement to audit and report on financial statements that have been previously audited and reported on (*i.e.*, a "reaudit"), "information obtained from [inquiries of the predecessor auditor] and any review of the predecessor auditor's report and working papers is not sufficient to afford a basis for expressing an opinion."^{16/} Instead, the auditor is required to plan and perform the reaudit in accordance with PCAOB standards, and is prohibited from assuming responsibility for the predecessor auditor's work.^{17/} Respondents did precisely the opposite. In lieu of planning and performing the required reaudit, they merely consulted with the prior auditor and relied on his work papers in issuing CBPC's audit opinion.^{18/} According to Bailey's

^{15/} See Health Discovery Form 8-K, filed on August 8, 2004.

^{16/} AU § 315.15, *Communications Between Predecessor and Successor Auditors – Audits of Financial Statements That Have Been Previously Audited*.

^{17/} AU § 315.16.

^{18/} On January 7, 2005, Health Discovery filed an amended Form 10-KSB for the year ended December 31, 2003, which substituted CBPC's audit report for that of the prior auditor. Health Discovery issued a contemporaneous press release announcing the amended filing and noting that "[n]o material changes were made to the financial information as originally filed." On July 18, 2005, Health Discovery filed a Form 8-K reporting that CBPC had withdrawn its audit report on the company's FY 2003 financial statements. The company disclosed that, as a result, its board of directors had concluded that those financial statements could not be relied upon. On August 16, 2005, Health Discovery filed a Form 8-K disclosing that it had engaged another auditor to re-audit its FY 2003 financial statements. On September 27, 2005, Health Discovery

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testimony, the only other work performed before issuing CBPC's audit report was a telephone call lasting "less than half an hour" with a Health Discovery employee and a review of the company's Form 8-K filings to evaluate events that occurred subsequent to December 31, 2003. Respondents did not do the audit planning or engage in the performance, supervision, or review of audit procedures necessary for CBPC to be able to issue an audit report on Health Discovery's FY 2003 financial statements. By issuing an audit report in those circumstances, Respondents violated PCAOB standards.^{19/}

C. Respondents Violated PCAOB Rules

27. PCAOB Rule 3100 requires that a registered public accounting firm and its associated persons comply with all applicable auditing and related professional practice standards. That requirement encompasses a requirement to comply with the PCAOB's interim auditing standards as described in PCAOB Rule 3200T. Respondents' failure to comply with PCAOB auditing standards, as described above, violated PCAOB Rules 3100 and 3200T.

IV.

In view of the foregoing, and to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports, the Board determines it appropriate to impose the sanctions agreed to in Respondents' Offers. Accordingly, it is hereby ORDERED that:

- i. Pursuant to Section 105(c)(4)(A) of the Act and PCAOB Rule 5300(a)(1), Clyde Bailey, P.C.'s registration with the Board is revoked; and

filed an amended Form 10-KSB for the year ended December 31, 2004, which included re-audited financial statements for FY 2003.

^{19/} The egregiousness of Respondents' failure in this regard is highlighted by the fact that less than eight months before CBPC's issuance of the audit report on Health Discovery, during a Board inspection of CBPC, the Board's inspection team identified a similar deficiency in a different engagement and pointed out to Respondents the seriousness of the deficiency.

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- ii. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), Clyde B. Bailey is barred from being an associated person of a registered public accounting firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i).

ISSUED BY THE BOARD.



J. Gordon Seymour
Acting Secretary

November 22, 2005