

**Inspection of  
Lazar Levine & Felix, LLP**

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

**August 29, 2005**

**THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT**

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

PCAOB RELEASE NO. 104-2005-054

**Notes Concerning this Report**

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

## **INSPECTION OF LAZAR LEVINE & FELIX, LLP**

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Lazar Levine & Felix, LLP ("the Firm"). The Board is 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 and portions of Part IV of the report. Part IV of the report consists of 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.

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<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 notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

<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") conducted fieldwork for the inspection from November 8, 2004 to November 18, 2004. The fieldwork included procedures tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:

Number of offices	3 (New York, New York; Parsippany and Morristown, New Jersey)
Ownership structure	Limited liability partnership
Number of partners	12
Number of professional staff <sup>3/</sup>	29
Number of issuer audit clients <sup>4/</sup>	22

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system.

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

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<sup>3/</sup> "Professional staff" includes all personnel of the Firm, except partners or shareholders and administrative support personnel. The number of partners and professional staff is provided here as an indication of the size of the Firm, and does not necessarily represent the number of the Firm's professionals who participate in audits of issuers or are "associate persons" (as defined in the Act) of the Firm.

<sup>4/</sup> The number of issuer audit clients shown here is based on the Firm's self-reporting and the inspection team's review of certain information for inspection planning purposes. It does not reflect any Board determination concerning which, or how many, of the Firm's audit clients are "issuers" as defined in the Act.

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>5/</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, are free of any deficiencies not specifically described in an inspection report.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of the performance of eight of the Firm's audits of the financial statements of issuers and of the Firm's review of interim financial information of a ninth issuer. 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.

The inspection team identified matters that it considered to be audit deficiencies.<sup>6/</sup> The deficiencies identified in six of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuers' financial statements. Those deficiencies included –

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<sup>5/</sup> When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations or cash flows of the issuer in conformity with GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

<sup>6/</sup> PCAOB standards require a firm to take appropriate actions to assess the importance of audit deficiencies identified after the date of the audit report to the firm's present ability to support its previously expressed opinions. *See* AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T). Failure to comply with these PCAOB standards could be a basis for Board disciplinary sanctions.

- (1) the failure to perform and document adequate testing of inventory of two issuers;
- (2) the failure to perform and document adequate procedures related to revenue recognition;
- (3) the failure to perform and document adequate procedures related to the existence of accounts receivable;
- (4) the failure to perform and document procedures to extend testing performed at an interim period to year-end; and
- (5) the pervasive failure to plan, perform, and document the audits of two issuers with insignificant or no operations.

**B. Review of Quality Control System**

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included a 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, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. As described above, 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

PARTS II AND III OF THIS REPORT ARE NONPUBLIC  
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

## **PART IV**

### **RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.



**Lazar Levine & Felix LLP**

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS CONSULTANTS

May 3, 2005

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

**Response to Draft Report on Inspection of  
Lazar Levine & Felix LLP**

Dear Mr. Diacont:

We are pleased to provide our response to the PCAOB regarding Part I of its draft Report on the inspection of our firm, which it conducted in November 2004. We strongly support the PCAOB's mission. We believe and agree with many other audit firms that the inspection process is an effective way to monitor the quality of audits, and that ultimately the inspections will restore the public's confidence in the audit of financial statements by independent auditors.

We believe that the ultimate result of the PCAOB's inspection process should be to improve the audit process. In that regard, the draft Report has identified areas where we can improve our audit performance. We have and we will continue to take steps to address each and every item in the Report.

Our response to the observations in Part I of the draft Report are set forth below. In addition, we have provided a few more detailed comments in response to the items in Part I of the Report in an Attachment to this letter, and we hope that you will consider this letter and the Attachment in preparing the final Report on the November 2004 inspection.



Mr. George H. Diacont  
May 3, 2005

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*Documentation Issue*

The staff identified several documentation deficiencies. We understand that the PCAOB has applied very rigorous standards to audit documentation and in fact, issued PCAOB Auditing Standard No. 3, which became effective after our inspection, and which incorporates those rigorous standards. Thus, in accordance with the standards applied by the Board we generally agree with the findings that audit documentation could be enhanced. As you know, from our previous responses to the PCAOB staff's comments, the audits under inspection were performed under AU sec. 339 (SAS No. 96), *Audit Documentation*, which in certain situations, does not specifically require documentation beyond audit programs (see Attachment). Accordingly, the signed-off audit programs, which existed and were observed by the inspectors, was an example of appropriate audit documentation at the time the audits were performed.

Based on the Board's comments, we have implemented procedures to improve our firm's audit documentation process in accordance with the new guidelines of the PCAOB, and we intend to continuously monitor our work product for compliance not only with the letter of but also with the spirit of AS 3.

*Departure From GAAP Issue*

The inspectors identified an equity transaction that was not appropriately accounted for, which they believe could potentially have resulted in a material misstatement of our clients' financial statements.

While this transaction was for a development stage entity with virtually no operations, in accordance with AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditors' Report*, our client has restated the financial statements to reflect the transaction.

We wish to note that while the \$750 and \$2,000 adjustments in years 2002 and 2003, respectively, that caused the restatements, may have been material to these particular financial statements because of the insignificant account balances in the financial statements, we believe that the changed amounts would be of little significance to the users of the financial statements.

*Other Matters*

The staff identified certain other matters related to the adequacy of audit procedures performed. Where we deemed it appropriate and in accordance with AU sec. 390, *Consideration of Omitted Procedures After the Report Date*, we performed additional audit procedures, and in all cases found and documented the evidence that further support our previously expressed opinions.



Mr. George H. Diacont

May 3, 2005

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We take seriously the staff's comments. While we believe our audit quality is high, we welcome constructive observations, and have taken concrete steps to enhance our commitment to continued quality service.

We understand that the draft Report, which will be available to the public, is critical by nature. We believe that a more balanced report, indicating the positive aspects as well, would give the public a more accurate picture of both the inspection process and the process of auditing financial statements in general.

We appreciate the opportunity to provide our response to Part I of the PCAOB's inspection Report. We hope our comments will be accepted as being constructive to the inspection process.

Very truly yours,

  
LAZAR LEVINE & FELIX LLP