

**Inspection of  
Malone & Bailey, PC**

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. 104-2005-055

**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 MALONE & BAILEY, PC**

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Malone & Bailey, PC ("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 29, 2004 to December 3, 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	1 (Houston, Texas)
Ownership structure	Professional corporation
Number of partners	2
Number of professional staff <sup>3/</sup>	9
Number of issuer audit clients <sup>4/</sup>	59

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 address appropriately, respects in which an issuer's financial statements do not present

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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 "associated 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.

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 nine of the Firm's audits of the financial statements of issuers. 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 three 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 opinions on the issuers' financial statements. Those deficiencies included –

- (1) the failure to perform and document adequate testing of the accounting for goodwill acquired in a business combination;

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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.

- (2) the failure to perform and document an evaluation of the issuer's lack of disclosure of the related party nature of a business combination;
- (3) the failure to perform and document an evaluation of the appropriateness of the issuer's accounting for a conversion of notes payable into common stock;
- (4) the failure to test the appropriateness of recording, and the valuation of, a contingent legal liability;
- (5) the failure to perform and document an adequate search for unrecorded liabilities; and
- (6) the failure to perform and document an assessment of the fair value of unproved oil and gas properties.

**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, 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.<sup>7/</sup>

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<sup>7/</sup> In its response to the public portion of the report, the Firm has chosen to make public its characterization of certain Board criticisms of the Firm's system of quality control. Consistent with the Act and Board rules, the Board does not make public, for at least 12 months, any criticisms of, or potential defects in, an inspected Firm's quality control system, and the Board therefore is not commenting on the Firm's characterization. The Board's silence should not be construed to indicate anything about the Board's view of the accuracy or completeness of the Firm's characterization.





May 5, 2005

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

by fax (202) 862-8433  
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Dear Mr. Diacont:

This letter is to transmit our proposed Part I public and Parts II and III private responses to your April 7, 2005 report on your December 2004 inspection of our firm.

Before you finalize your report and post it with our proposed responses on your website, we request you consider the following:

- Correct our address. We moved 18 months ago; and
- Reconsider the harshness of your report. We simply believe it is not reasonable in the circumstances, as explained in our responses.

We are happy to discuss the content of your report and our responses. Obviously, we would appreciate the opportunity to revise our responses if you change your content in any fashion.

Yours very truly,

John C. Malone, JD, CPA  
Managing Partner

Registered Public Company Accounting Oversight Board  
AICPA Center for Public Company Audit Firms  
Texas Society of Certified Public Accountants



May 5, 2005

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

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Dear Mr. Diacont:

We are pleased to provide our response to your report on your December 2004 inspection of our SEC auditing practice.

First of all, we support your mission, as required by the Sarbanes-Oxley Act of 2002. Your inspection team is professional and qualified, with the exception of their lack of expertise in the area of small company auditing, as more fully described in this response. Your close scrutiny of public company auditing practices is just what our profession has needed. We intend to use the feedback from your scrutiny to help us hone and fine-tune our audit quality and quality-control procedures which are in place to ensure the highest standards of excellence in our audits.

Secondly, we disagree with several of PCAOB's findings regarding our firm due to the following:

- As has always been, auditing involves the use of judgment,
- We don't believe that the PCAOB staff that conducted our review have the breadth of small business auditing experience, or an understanding of small businesses to be able to accurately examine our audit quality. This critical lack of experience and understanding is what we believe led to your handful of mischaracterizations of our audit work as described in your report. A basic tenet of auditing is that you must understand the nature of the business you audit. Small public companies are substantially different from larger public companies in a number of areas, including:
  - Small public companies are typically run by entrepreneurs where large ones are typically run by professional managers;
  - Small public companies have very basic books, and a limited talent pool to manipulate or complicate them. When a general ledger for the year is only a few hundred pages or less, it isn't hard to review the entire thing; and

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Texas Society of Certified Public Accountants

- Small companies tend to skimp on layers of documentation, for simplicity and to save money, which is a premium tenant in small business, where costs have to be carefully managed.

We are one of the largest non-national providers of small public company audits. We specialize in audits of small public companies, unlike almost all of our competition, and excepting the handful of sole practitioners out there that still practice in this area. Over 85% of our revenues are from the audits of small public companies. Our professional staff spend nearly all of their time on exactly these procedures, company after company. We are experts in this area and at the types of audit procedures that best serve this market.

Many of the small companies that we audit are not economically viable. Two of the three companies that the PCAOB faulted our audits on had minimal assets and revenues and large expenses. The third had substantial cash and intangible assets, but minimal revenues and very large expenses. Many seasoned auditors would agree that, excepting large isolated transactions, equity and debt transactions, that the audit risk would generally be low with these companies because there are (likely to be?) no investors relying on the financial statements to make their investment decisions. None of these three companies has ever been an institutional investment-grade candidate.

The following are our detailed comments regarding PCAOB's findings presented on their report dated April 7, 2005 and covering their review of our firm in early December 2004:

- A. Number of partners - PCAOB says we have two partners, and we did have only two for the period of July 5, 2004 through January 16, 2005, which did include PCAOB's visit and a part of the period under examination. Prior to July 5, we had four partners and after January 16, 2005, we now have three partners. Excepting this brief interruption, we have not had fewer than three partners since February 2001. PCAOB staff were given the opportunity to meet our new third partner when they were in our office in December 2004 and they declined.
- B. PCAOB-identified audit "failures." We highly dispute the characterization of their findings as "failures." These are more accurately "differences of opinion" and not "failures." The items identified in your report are as follows:
  1. Alleged "failure" to test adequately the accounting for goodwill acquired in a business combination.
    - We believe this is a mischaracterization;
    - We did test this adequately, and we stand by our testing and conclusions. PCAOB staffers did not challenge our methodology, evidence or conclusions when they were in our office;
    - We believe the actual issue is that we did not provide the depth of written documentation that PCAOB staffers thought was appropriate; and
    - In June 2004, PCAOB released their Auditing Standard No. 3, covering Audit Documentation. In this standard, PCAOB changed the long-standing AICPA policy of allowing verbal or oral testimony on audit documentation, to prohibit

such and require all documentation to be written. While we support the purpose of this rule change, asking all firms everywhere to change a 100-year tradition (30 years of training in the engagement partner and 29 years in the concurring partner) overnight is a tall order. We acknowledge that this was a minor oversight on our part and we have taken steps to ensure that our audits include the appropriate depth of documentation.

2. Alleged "failure" to ascertain and properly address the related party nature of a business combination (the same one in Issue No. 1 above) and the issuer's lack of disclosure of the related party nature of the transaction.
  - We believe that this is also a mischaracterization;
  - We believe that we did ascertain and properly address the related party nature of the transaction;
  - This client disclosed the related party nature of the transaction upfront and all officers and attorneys involved were aware of it; and
  - We acknowledge that we did fail to disclose the related party nature (as did the client and the securities attorney involved with the filing), and we consider this only a minor oversight because of the nature of the client and the transaction. The client was (and still is) not viable economically and has always been supported by 7-figure annual major stockholder loans and purchases of client equity securities, supporting 7-figure annual total expenses with only low 6-figure annual gross revenues.
3. Alleged "failure" to consider the appropriateness of the issuer's accounting for a conversion of notes payable into common stock.
  - We did consider this, and the amount was immaterial. In that year, revenues were \$117,000, expenses \$1,570,000, total assets \$170,000 and total liabilities \$920,000. The effect of recording this adjustment was to overstate interest expense (and paid-in capital) by \$145,000, or about 10% of the total net loss. The SEC's definition of 'materiality' is "any adjustment which might cause a potential investor to alter his investment decision." In our opinion, this item does not reach that threshold;
  - The stocks of many of these smaller public companies are sold as purely speculative investments. Informed purchasers largely ignore the financial statements because they already know these entities are not viable economically today. A non-viable entity can lead to a lower audit risk assessment, all other things being equal. If an entity with \$100,000 in revenues a year has a \$1.5 million loss, then it is immaterial whether that loss should have been \$2 million or only \$1 million. The entity still isn't economically viable. Financial analysis wouldn't produce any useful information. Our accounting profession should always do the best job possible, but when the standard of materiality as defined by SEC isn't met, then we can't spend the same kind of time studying all facets of a set of books as we would with a similar-sized company which is economically viable and for which the financials are closely scrutinized by informed investors.

4. Alleged "failure" to test the appropriateness of recording, and the valuation of, a contingent legal liability.
  - In our view, this is another mischaracterization;
  - This is the same audit as No. 3 above, so the same materiality threshold (or lack thereof) applies;
  - The amount involved was somewhere between \$75,000 (the client's offer in mandatory arbitration under Canadian law, payable in stock) and the client-characterized "maximum worst case" of \$165,000. The case has not settled to date and the client still maintains it is without merit;
  - We did consider this as well, and the amount was immaterial; and
  - The effect of not recording this liability was to understate expenses by \$75,000 - \$165,000, or about 5 - 11% of the total net loss. Note that this offsets the alleged overstatement per No. 3 above.
  
5. Alleged "failure" to perform an adequate search for unrecorded liabilities.
  - This is the same client as mentioned in No. 3 and 4 above; and
  - In our view, we did not have a "failure to perform" but rather a "failure to document" why the procedures performed did not agree with what the audit program required. The audit program assumed a "moderate" level of audit risk in this area, whereas we had assessed a "low" risk, based on various factors, including the key performance numbers as summarized in No. 3 above. We consider the procedures performed adequate in the circumstances, and we did not fully document this in writing as just recently required beginning June 2004 under PCAOB's Auditing Standard No. 3 (and as discussed in No. 3 above).
  
6. Alleged "failure" to perform and document an assessment of the fair value of unproved oil and gas properties.
  - We feel that this is another mischaracterization by PCAOB.
  - We did properly assess these assets, but we failed to completely disclose our deliberations in a memo as required under the new PCAOB Auditing Standard No. 3.
  - We stand by our testing and conclusions.

We sincerely believe that the prevailing risk-based auditing standards should allow lesser procedures and documentation for small public companies where low risk assessments are made and justified in an effort to keep the cost of auditing reasonable for these small public entities.

In summary, we consider three of the six issues (as outlined above in No. 1, 5 and 6) that the PCAOB noted to be minor technical violations of the brand-new PCAOB Standard No. 3 and we are committed to ensure that the procedures outlined in PCAOB Standard No. 3 are followed. The fourth issue outlined in No. 2 above is a minor related party disclosure violation, and the fifth and sixth issues, as discussed in No. 3 and 4 as offsetting and immaterial financial statement adjustment errors. Please note that the referenced related party disclosure was added in the recent December 31, 2004 Form

10-KSB (for unrelated reasons, the client changed its fiscal year-end to December 31 this past winter).

PCAOB's Part B, Review of Quality Control System, implies that there was at least one defect or criticism of our quality control system. This is not initially made public, but we would like to take this opportunity to state that PCAOB's findings here were three matters that:

- Having only two audit partners for our large public company practice was insufficient;
- We "failed" to use custom audit programs; and
- We "failed" to fully document concurring partner reviews.

We believe that the PCAOB criticism of our quality control system for the reasons outlined above is indicative of a lack of experience and understanding of small public company auditing on behalf of the PCAOB audit team assigned to this review of Malone & Bailey's.

As noted previously, we currently have three audit partners, not two, and the explanation of our special circumstances regarding our temporary reduction of audit partners given to PCAOB was seemingly ignored. In addition, "custom" audit programs are rarely used in audits of small businesses, unless for a specialized industry. The prevailing standard is, and has always been, to use standard audit programs on all engagements, with documentation of departures therefrom available either orally or in the work papers themselves. We use the complete practice aid system of Practitioners Publishing Company (PPC), which is our industry standard and is widely praised and used by many non-national firms. We maintain that the PCAOB should strive to fully understand the differences between, and issues related to, small public companies and large public companies before venturing more such criticisms.

Lastly, until recently, there were no nationally-promulgated checklists or other audit practice aids to document concurring partner reviews, so we had designed our own. We believe that the PCAOB is inappropriately criticizing an area of documentation where no standards have previously existed by practice aid systems such as PPC.

PPC has recently produced a new set of audit programs, checklists and other practice aids exclusively for use in the audit of small public companies, including enhanced documentation of concurring partner reviews. We adopted these documentation standards in January 2005.

In final summary, we provide the following comments:

Because we are one of the very few non-national firm that specializes exclusively in the audits of small public companies, we believe that we are uniquely qualified in this area. We believe that no firm may competently practice in this area with fewer than 15 SEC reporting clients, nor with fewer than three well-trained SEC specializing partners. While there may be another firm or two in the nation that equals our qualifications and experience, we believe the paucity of such is a major problem confronting our profession and that the SEC and Congress have set unreasonably high standards for

practice in the area of small public company auditing due to the cost constraints facing the companies who are subjected to these standards. However, we fully believe our firm is up to this challenge and we are striving to adopt the standards as they are handed down.

Because auditing is clearly a balance of methods and judgment, and because the new PCAOB Auditing Standard No. 3 just came out prior to your inspection team's visit of our firm in December 2004, we believe pointed PCAOB criticism such as made of Malone & Bailey, PC in your April 7, 2005 report is not appropriate and could be misleading. While we have no problem with PCAOB pointing out such perceived discrepancies privately, however, we recommend that PCAOB delete references to a lack of audit documentation until the profession has been given a chance to more fully implement the new standard. We also recommend that the PCAOB put into context their discussion of the immaterial offsetting possible-but-not-made audit adjustments - that is, acknowledge that the adjustments offset each other.

Finally, PCAOB has performed examinations of the auditing and quality control systems of the four largest firms, and of 95 other firms during 2003 and 2004. As of the date of our response, PCAOB has published only nine full reports on such inspections. None of the nine firms on which these reports are based has the experience nor volume of small public company audit experience as we do, so any premature public comparison is misleading. Each of the 4 national firm 'limited' inspection reports reported multiple instances of inadequate documentation and erroneous conclusions. We recommend that PCAOB not release these reports piecemeal until more valid comparisons are forthcoming. Only on a 'level playing field' where all firm reports are available (or at least a larger sampling, especially of the handful of firms that have a practice comparable to ours), is such a review or report meaningful or relevant to informed readers.

We believe that our reputation for quality and integrity with the Securities and Exchange Commission and with legal and other auditing practitioners is at the highest levels.

We appreciate the opportunity to comment, and our comments are made only in the spirit of cooperation and with the commitment to keep financial reporting in the United States the best, and most reliable, in the world.

Yours very truly,



John C. Malone, JD, CPA  
Managing Partner  
Malone & Bailey, PC