PCAOB
Public Company Accounting Oversight Board

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# Inspection of
# Staples, Larkin and Associates, LLP

**Issued by the**

## Public Company Accounting Oversight Board

**July 25, 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. 104-2005-033

Public Company Accounting Oversight Board

PCAOB Release No. 104-2005-033

**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.

PCAOB Release No. 104-2005-033

# INSPECTION OF STAPLES, LARKIN AND ASSOCIATES, LLP

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Staples, Larkin and Associates, 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.[1/]

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.[2/] 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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[1/] 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.

[2/] 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 September 20, 2004 to September 23, 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:

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|---|---|
| Number of offices | 1 (Palestine, Texas) |
| Ownership structure | Limited liability partnership |
| Number of partners | 2 |
| Number of professional staff[3/] | 1 |
| Number of issuer audit clients[4/] | 1 |

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 fairly the financial position, results of operations, or cash flows of the issuer in

[3/] "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.

[4/] 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.

conformity with GAAP.[5/] 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 a review of aspects of the performance of the Firm's audit of the financial statements of its issuer audit client. Those 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.[6/] The deficiencies identified 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 issuer's financial statements. Those deficiencies included –

(1) the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to a potentially material misstatement in the audited financial statements concerning the recording and disclosure of payroll expense;

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[5/] 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.

[6/] 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 testing of the valuation and classification of inventory;

(3) the inappropriate reliance on the work of another auditor that assisted in the audit;

(4) the failure to perform and document testing of the propriety of the amount of deferred income taxes disclosed in the notes to financial statements;

(5) the failure to perform and document testing of the existence and completeness of accrued payroll taxes;

(6) the failure to perform and document an evaluation of the fair value of restricted stock issued in exchange for services;

(7) the failure to evaluate prior year balances audited by another auditor; and

(8) the failure to evaluate whether the issuer should restate its prior year's financial statements to eliminate the recording of stock subscriptions receivable that had expired before the close of that year.

B. Review of Quality Control System

In addition to evaluating the quality of audit work performed on a specific audit, 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.

END OF PART IV

**STAPLES, LARKIN AND ASSOCIATES, L.L.P.**
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May 16, 2005

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

Re: Response to PCAOB Inspection Report, Part I

Dear Mr. Diacont:

The following information is the firm's response to the eight points raised in Part I of the PCAOB Inspection Report of Staples, Larkin & Associates, LLP:

1. Payroll expense.

The firm accepted the issuer's approach because the firm believed the future payment of the salaries in arrears was unlikely. In addition to meeting the other requirements of accounting principles, an accrual should be based in reality.

2. Inventory valuation.

The issuer believed that is was on the verge of breakthrough in its processes, would soon be out of the development stage and would be selling its products on a regular basis. The firm believed the carrying of the issuer's inventory as current was appropriate.

3. Use and supervision of other auditors to perform audit procedures.

The firm independently contacted the other accounting firm to observe the physical inventory and fixed assets. The other firm confirmed orally that their firm and all associates of their firm were indeed independent of the issuer. The firm believes its level of knowledge of the issuer was sufficient to ensure that the other accounting firm was independent of the issuer.

4. Income taxes.

The source for the Federal net operating loss carry forwards is a work paper that is an excerpt of the fiscal year ended May 31, 2001, Form 10-K section that listed the issuer's net operating loss carry forwards. In addition, the firm has the Federal corporate income tax returns for the fiscal year-ends May 31, 1999, 2000 and 2001 in a tax file at the firm's office.

Due to the uncertainty of the issuer's likelihood of showing a profit, the firm believed that the issuer's valuation allowance entirely offsetting the deferred tax assets was proper in accordance with Statement of Accounting Standards No. 109.

5. Payroll taxes.

In the firm's initial response to the inspection team, the firm agreed that its work paper to document the procedures regarding this liability balance was not clear, but the firm did perform procedures that were stated on the work paper and we believed that the procedures were sufficient to determine that the liability was materially correct.

6. Testing of fair values.

The firm obtained high, low and average stock prices for the 2002 fiscal year. For the months of June through August 2001, the firm obtained stock prices from Bloomberg. For the months of September 2001 through May 2002, the firm obtained a schedule from a non-employee of the issuer that had performed bookkeeping services for the issuer. The prices were in line with the previous Bloomberg reports, with little variation. Firm personnel had checked stock prices through an internet financial web site and concluded that the prices used to value the stock issuances were reasonable. A contemporary check of the internet financial web site at the time of the firm's inspection supported that the prices used were in line.

7. Reliance on prior year balances audited by another auditor.

The independent auditor report introductory and opinion paragraphs both should not have included the phrase "and for the period from inception through May 31, 2002".

The firm will mail a paper copy of this response to the PCAOB.

Yours very truly,

*Staples, Larkin & Associates, L.L.P., CPAs*

Staples, Larkin & Associates, LLP