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## **Inspection of Stovall, Grandey, & Whatley, 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. 104-2005-064**

**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 STOVALL, GRANDEY, & WHATLEY, LLP**

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Stovall, Grandey & Whatley, 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 July 6, 2004 to July 9, 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 (Fort Worth, Texas)
Ownership structure	Limited liability partnership
Number of partners	3
Number of professional staff <sup>3/</sup>	10
Number of issuer audit clients <sup>4/</sup>	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

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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 Engagement

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.<sup>6/</sup> 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 failure to test the valuation of available-for-sale securities;
- (2) the failure to evaluate the quality and effectiveness of an internal auditor's work sufficiently to support the use the Firm made of that work;

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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.

(3) the failure to test internal controls sufficiently to support the Firm's control risk assessment that formed the basis for reduced substantive audit procedures; and

B. Review of Quality Control System

In addition to evaluating the quality of the 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



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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.



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May 4, 2005

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

Re: *Responses to Draft Report of Inspection of  
Stovall, Grandey, & Whatley, LLP*

Dear Mr. Diacont:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB's) preliminary report of inspection (the "*Report*") of the firm of Stovall, Grandey, & Whatley, LLP. The inspection process is a fundamental component of the PCAOB's mission.

Our overall objective is to make certain that all aspects of our auditing and quality control processes are of the highest quality. While we believe that our audit quality is exceptional, we expect and welcome fair and constructive observations of our policies, procedures and implementations. We have taken, or will be taking, steps to address all of the matters described in the *Report*.

We are concerned, however, that the *Report*, which concentrates on a few identified issues, does not adequately portray the overall high level of audit quality that exists within our firm and that readers of the *Report* will not have a complete picture of our audit quality. No issues were identified related to the accuracy of total assets, liabilities or equity, or to the accuracy of total revenues or net income. To that end, we emphasize that the financial statements of the issuer inspected and our report thereon did not have to be reissued.

The inspection team identified certain matters considered to be audit deficiencies. We understand that reasonable people can differ on the nature, timing and extent of audit procedures required to be performed in certain circumstances. We have had years of experience working with financial institutions and understand areas of risk related to their industry. As discussed further in our responses to each finding below, we believe procedures we performed do provide sufficient and competent evidential matter to support our opinion on the issuer's financial statements. However, in the spirit of cooperation, we performed additional procedures as requested by the PCAOB. The results further supported our original opinion. Therefore, we respectfully request that your final report exclude the statement: "*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.*"

**Part I**

We have included below our responses to Part I of the *Report*, primarily to provide our views on particular findings and to add context to the reported findings. We request that you consider our comments in preparing your final report on our inspection.

*(Part I.A.1, page 3)* The issuer has used the same third party portfolio manager for a number of years. The issuer's investment portfolio is very conservative, consisting primarily of government guaranteed agency bonds. The existence and cost of these bonds were confirmed and the stated market value was approximately the same as the amortized cost which was reasonable and consistent with the nature of the portfolio and, in our judgment, would not have been materially misstated. While we believed our procedures were sufficient to support our opinion, we subsequently tested the valuation of the portfolio, with no exceptions, and added contemporaneously dated documentation to our audit files.

*(Part I.A.2, page 3)* The issuer has used the same third party to perform independent loan file reviews for many years. We tested, without exception, the accuracy of the loan file review performed by the third party in previous audits. During the planning phase of this engagement, we determined that we could increase our loan review coverage by reviewing the third party's report and independently testing similar loan files versus reperforming work of the third party as we had done in previous years. However, while we believed our procedures were sufficient to support our opinion, we subsequently selected a sample of the loan files reviewed by the third party and reperformed the loan file review. We determined that the results of the additional procedures supported our original conclusion. We added contemporaneously dated documentation to our audit file.

*(Part I.A.3, page 3)* The internal audit function is outsourced to a third party which reports directly to the audit committee. The competency and objectivity of the third party has been tested through observation and inquiry over several years with this issuer and in other financial institution engagements. We received the results of the internal audit procedures throughout the year and we participated in the discussion of those results in the issuer's audit committee meetings. While we believed the procedures we performed, combined with the work of the internal auditor, were sufficient to support our opinion, we prepared and added to our audit documentation contemporaneously dated work papers that support our consideration of the competency and objectivity of the internal audit function and our reperformance of certain internal audit procedures.

*(Part I.A.4, page 3)* The extent of procedures to be performed supporting a control risk assessment below maximum is subject to auditor judgment. We considered the procedures performed sufficient to support the assessed level of control risk. However, based on PCAOB recommendations, we expanded our control testing in that area to include additional controls that were in place throughout the year. We added contemporaneously dated audit documentation to our work paper file.

*(Part I.A.5, page 3)* We agree with the description of the facts as presented. We performed the required procedures and added contemporaneously dated documentation to our work paper file. In addition, we developed an audit program to be used for subsequent events procedures and to be applied in all situations before issuing consent in the future.

***This is the end of Part I.***

Redacted  
Comments on Non-public Aspects of Report

We are respectful of the PCAOB's inspection process and understand that judgments are involved. We made every effort to cooperate with the inspection staff by performing additional procedures or preparing additional documentation to satisfy their requests. While performing the additional procedures, no facts were identified that would have affected our opinion on the financial statements of the issuer. We are committed to continuously improving the quality of our audits and accepted the PCAOB's observations with that spirit in mind.

We appreciate the opportunity to provide our responses to the *Report*. We would welcome discussion of any matters that require further explanation before you finalize the *Report*.

Respectively submitted,



David G. Stovall  
Partner