

**Inspection of  
Pugh & Company, P.C.**

**Issued by the**

**Public Company Accounting Oversight Board**

**November 30, 2006**

**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**



### **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 PUGH & COMPANY, P.C.

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Pugh & Company, P.C. ("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 October 31, 2005 to November 3, 2005. 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 (Knoxville, Tennessee)
Ownership structure	Professional corporation
Number of partners	9
Number of professional staff <sup>3/</sup>	32
Number of issuer audit clients <sup>4/</sup>	5

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

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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.

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 three 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 all 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 opinion on the issuer's financial statements. Those deficiencies included –

- (1) the Firm's failure to identify, or to address appropriately, departures from GAAP that related to potentially material misstatements in the audited financial statements concerning stock-based compensation and earnings per share; and

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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 sufficient audit procedures to test the adequacy of the allowance for loan losses for two financial institution issuers.

Following the inspection fieldwork and the inspection team's discussions with the Firm of the matters above, one issuer restated its financial statements to address GAAP departures identified by the inspection team.<sup>7/</sup>

**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

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<sup>7/</sup> The Board inspection process did not include any review of any additional audit work or the restated financial statements.

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.

**PUGH & COMPANY, P.C.**  
CERTIFIED PUBLIC ACCOUNTANTS

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June 12, 2006

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

RE: Responses to Part I of your Draft Report of Inspection dated May 15, 2006

Dear Mr. Diacont:

We appreciate the opportunity provided to us to respond to Part I of your Draft Report of Inspection dated May 15, 2006 and we request that this letter related to Part I be made part of the final report. We respect your efforts as mandated by Congress to provide oversight to the accounting profession for auditing and reporting related to public companies and we share in your desire to use this process as a means of improving audit quality. As part of that process, we provide the following responses to your draft report for your consideration.

REVIEW OF AUDIT ENGAGEMENTS

We disagree with the comments in the second paragraph of Section A of Part I that we did not obtain sufficient competent evidential matter to support our opinion on the issuers' financial statements in all three of the audits that the inspection team reviewed. We agree that in regard to one issuer only, and specifically related to stock-based compensation and earnings per share for that one issuer only, we rendered an audit opinion that was not appropriate under the circumstances. Subsequent to the inspection, we expended significant resources to research all of the related GAAP requirements specific to these issues, including hiring at our own expense an independent audit professional to review our research and conclusions reached. We discussed the apparent departures from GAAP in the issuer's financial statements with the issuer as soon as we completed our research, and the issuer's financial statements included in their December 31, 2004 10-KSB and their March 31, 2005 and June 30, 2005 10-QSB's were subsequently reissued. As discussed in detail below, the deficiencies in the financial statements that were restated were related to stock-based compensation and earnings per share computations, two issues that are very complex and for which the guidance has changed several times over the past few years.

In Part IA(1) of your draft report you state that we failed to identify, or address appropriately, departures from GAAP related to stock-based compensation for one issuer. As discussed above, in our opinion, we specifically failed to perform sufficient additional follow-up research of GAAP subsequent to changes in the way that the issuer's stock options were originally designed to be issued and exercised. Specifically, the issuer originally issued its stock options in 1999 with an exercise price equal to estimated fair value. In accordance with APB Opinion No. 25 and FIN 44, the issuer did not record any compensation expense when its stock options were issued. Several years later, when the issuer was engaged in purchasing and retiring its stock on the open market, which was not originally anticipated or considered in our initial research, some of the stock options were exercised and the issuer immediately purchased the stock for cash and retired the stock. Our failure to update our research of APB Opinion No. 25 and FIN 44 at the time that the stock was immediately repurchased by the issuer resulted in us issuing our opinion on the issuer's original financial statements inappropriately. The issuer should have recorded compensation expense for the amount of cash paid for the stock less any statutory federal or state tax withholding and payroll taxes paid from the proceeds.

In our opinion, the error which caused our inappropriate opinion was a failure to carefully update our previous research of GAAP when the actual transactions were different from the transactions that we originally expected to occur in the future. We have held several discussions with our staff concerning the importance of updating research when the nature of subsequent transactions changes from what was originally expected.

Also in Part IA(1) of your draft report you state that we failed to identify, or address appropriately, departures from GAAP related to earnings per share for the same issuer. In our opinion, we failed to identify the appropriate circumstances under which certain shares of stock should be excluded from the calculation of earnings per share (EPS). Specifically, the issuer included shares of stock that were held in trust to be issued upon exercise of outstanding stock options since these shares earned and were paid dividends. Income attributable to these shares was not available to other stockholders. Therefore, initially, we concurred with the issuer that exclusion of these shares from the number of shares outstanding would be misleading. Upon further research we determined that these shares should have been excluded from EPS since they were under the control of management and the board of directors. Also, the issuer included in shares outstanding those shares held in a rabbi trust as a long-term incentive plan for directors. Our research of SFAS No. 128, paragraph 10, initially led us to believe that these shares should be considered outstanding since these shares "were issuable for little or no cash consideration upon the satisfaction of certain conditions" (i.e., retirement of the directors). Upon further research of Emerging Issues Task Force ("EITF") 97-14, we have now determined that these shares should not have been considered outstanding since the obligation to the directors could have been settled by delivery of cash or the issuer's stock. In our opinion, we should have considered all of the facts and circumstances related to the control of the shares held in the stock option trust. Specifically, these shares should not have been considered outstanding since they were under the control of management and the board of directors. We should also have extended our research related to the shares held in the rabbi trust to EITF 97-14 rather than FAS 128 alone. We have provided training for all of our staff members concerning EITF 97-14 and FAS 128 related to the computation of EPS.

In Part IA(2) of your draft report you state that we failed to perform and document sufficient audit procedures to test the adequacy of the allowance for loan losses for three financial institution issuers. We disagree with the use of the word "perform", because in our opinion, we did perform sufficient audit procedures to test the adequacy of the allowance for loan losses for all three of the financial institution issuers included in the inspection. We do agree that the documentation of the procedures we performed should have included all of the information we considered and used in performing our audit work as required by PCAOB Auditing Standard No. 3 (AS No.3). It is important to note and consider that the SEC did not approve AS No. 3 until August 25, 2004 (effective for 2004 audits) which allowed us only 4 months to provide the training that we and our staff needed to implement a standard that is significantly different and more stringent than the documentation standards that were required for non-issuer audits in 2004. In our opinion we substantially complied with the new requirements. The allowance for loan losses for financial institutions is a subjective estimate and requires the auditor to assess the amount of the allowance using several different techniques. We utilized all of the techniques we considered necessary under the circumstances and in each case, in our opinion, the allowance for loan losses of each of the issuers included in the inspection was, and still is, considered adequate and not excessive. We feel that it is very important to note that determining the sufficiency of evidential matter in any audit engagement involves a great deal of professional judgment related to the particular circumstances, including the audit professionals' knowledge of each individual issuer's business or industry. Accordingly, determining what is sufficient is one of the more difficult areas for professionals to reach a mutual agreement.

All three of the issuers included in the inspection are regulated by multiple federal banking regulators, and in one case, also regulated by a state banking regulator. Federal and state banking regulators require each of the issuers to (1) obtain an unqualified opinion on their audited financial statements, (2) use generally accepted accounting principles in their financial reporting and (3) maintain their loan loss reserve at a level that the federal and state banking regulators believe is adequate. The SEC, the FASB, the AICPA, and the federal and state banking regulators are evidently not in agreement with what constitutes GAAP in relation to bank loan loss reserves. Given that the calculation is subjective to some degree, and that each of the regulatory agencies have different agendas or concerns relative to the amount of the loan loss reserves that would be considered appropriate, it is relatively easy for any of the regulators to find fault with the work performed in both calculating and auditing this type of subjective estimate. In our opinion, these federal agencies and other entities must first agree on the appropriate calculations and auditing procedures related to loan loss reserves for banks in the U.S. before local banks and CPA firms can attempt to comply with each of their separate wishes.

We have provided additional training for all of our staff related to the requirements of AS No. 3 in general, as well as the requirements of documentation as they relate to the audit of the allowance for loan losses of financial institution issuers. In our opinion, we have provided sufficient additional training concerning the required workpaper documentation standards so that we will be in compliance with the requirements of AS No. 3 in the future. We take the inspection process and our resulting responsibilities very seriously and we are committed to improving our Firm and the profession's performance wherever possible. Although we realize that the inspection process is designed to identify and focus upon areas which need improvement, it is important to note that the format of the draft report does not lend itself to portraying the overall high quality existing in our audit practice.

Please contact Larry Elmore at 865-769-1632 if you need additional information or if we need to discuss any of these matters further.

Respectfully submitted,

*Pugh & Company, P.C.*

Certified Public Accountants