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Public Company Accounting Oversight Board

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Inspection of
Shapley, Shapley & Moorhead, C.P.A.'s, P.C.

Issued by the

Public Company Accounting Oversight Board

July 13, 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

PCAOB RELEASE NO. 104-2006-152A
(Includes portions of Parts II and IV of the full report that were not included in PCAOB Release No. 104-2006-152)

PCAOB
Public Company Accounting Oversight Board

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
Public Company Accounting Oversight Board

INSPECTION OF SHAPLEY, SHAPLEY & MOORHEAD, C.P.A.'S, P.C.

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Shapley, Shapley & Moorhead, C.P.A.'s, 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.[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.

[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 12, 2005 to September 13, 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 (Davenport, Iowa)
Ownership structure	Professional corporation
Number of partners	2
Number of professional staff[3/]	3
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 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.[6/] The deficiencies identified included a deficiency 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. That deficiency was the Firm's failure to perform and document sufficient audit procedures related to revenue recognized from the sale of real estate.

[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.

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

PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

PART II

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B. Issues Related to Quality Controls

The inspection of the Firm included consideration of aspects of the Firm's system of quality control. Assessment of a firm's quality control system rests both on review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements.[7/] On the basis of the information reported by the inspection team, the Board has the following concerns about aspects of the Firm's system of quality control.

1. Audit Performance

A firm's system of quality control should provide reasonable assurance that the work performed on an audit engagement will meet applicable professional standards and regulatory requirements. On the basis of the information reported by the inspection team, including the audit performance deficiency described in Part II.A and any other deficiencies identified below, the Board has concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects –

a. Technical Competence, Due Care, and Professional Skepticism

The Firm's system of quality control appears not to do enough to ensure technical competence and the exercise of due care or professional skepticism.

b. Concurring Partner Review

Questions exist about the effectiveness of the Firm's existing arrangement for concurring partner reviews. Having procedures for concurring partner review by a competent reviewer is an important element of quality control. Such reviews should

[7/] A firm's failure to comply with the requirements of PCAOB standards when performing an audit may be an indication of a potentially significant defect in a firm's quality control system even if that failure did not result in an insufficiently supported audit opinion.

involve the performance of appropriate procedures using due care and professional skepticism, with the Firm appropriately addressing the reviewer's findings and documenting the process. The information reported by the inspection team suggests that there is no evidence that the concurring partner review procedure used by the Firm resulted in the identification of the deficiency noted by the inspection team. This may result from a lack of competency, due care or professional skepticism on the part of the concurring partner; deficiencies in the scope of the concurring partner's procedures; and/or the Firm's failure to properly address the concurring partner findings. Apparent deficiencies in documentation of the scope and results of the concurring partner's reviews preclude the Board from determining the relative contribution of each of these potential causes to the failure of the concurring partner process to prevent the deficiency reported by the inspection team.

2. Independence

The Firm's system of quality control appears not to provide reasonable assurance that the Firm will comply with independence requirements. As described in Part II.C below, the inspection team reported information indicating that the Firm may not have been independent of its issuer client within the meaning of the Commission's independence requirements. [Issuer A]

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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.

SHAPLEY, SHAPLEY & MOORHEAD, P.C.
Certified Public Accountants
3910 N. Lillie Avenue, Davenport, IA 52806 Phone (563) 388-4744 Fax (563) 388-4748

May 2, 2006

Via Facsimile

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

Re: Response to Inspection Report

Dear Mr. Diacont:

The Inspection Report issued as the result of the PCAOB's inspection of September 12-13, 2005 stated an audit deficiency of such a magnitude "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. That deficiency was 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 revenue recognized from the sale of real estate."

The issuer invests in real estate/real estate contracts (primarily single-family residences). The investments in real estate are sold to third-party purchasers. Upon the sale of the property, the issuer records the full amount of the gain and records the amount due from the purchaser as a contract receivable. Of the six new contracts recorded on the books of the issuer during the year ended September 30, 2004, four of the contracts were purchased at the contract balance, and had no gross profit. The remaining two contracts had a gross profit of $11,130. The materiality threshold for this audit was $14,550.

The primary source of income for this issuer is the 12% interest income on the contracts, not the gross profit. The history of the contracts held by the issuer is that the contracts are usually refinanced by the mortgagee within 18-24 months of when they are initiated. Of the 18 contracts that the issuer had when we first audited there records in 1999 with a gross profit of $7,495, all had been refinanced and the gross profit realized by 2002.

In our judgment, to record these sales using the deferred gross profit method as outlined in SFAS 66 inaccurately reflected the true results of the issuer for the year of sale, deferring the gain recognition twelve to eighteen months. In addition, the difference in income recognition was immaterial as calculated for this audit.

The Inspection Report also cites our Firm for a lack of technical competence, due care, professional skepticism, and questions the effectiveness of our concurring partner review. The question of revenue recognition, as stated in the preceding paragraphs, were addressed in each of our two peer reviews conducted for the years ended March 31, 2003 and March 31, 2000. At the time of those reviews, our peer review firm sent the audit file for the issuer to a "SEC specialist" for review. On both occasions, the SEC specialist inquired into the revenue recognition method we were using. We responded with the same set of facts as we have outlined in the preceding paragraphs, and both the peer reviewer and the SEC reviewer concluded that the method of income recognition we were using was correct with respect to the facts and circumstances of this issuer. The notion that we lacked technical competence, did not exercise due care or professional skepticism, and that our concurring partner review was inadequate couldn't be further from the truth. We have reviewed this issue repeatedly over the years and have always come to the conclusion, along with the conclusion of outside reviewers, that our audit was performed properly and that our system of quality control was operating properly. If it is the opinion of the SEC and the PCAOB that we should adopt SFAS 66 in all cases of real estate sales in which down payments do not exceed 5%, regardless of the facts and circumstances of the case, we will convert this issuer to that method of income recognition.

The Inspection Report also cites our Firm for a lack of independence. The facts of this case are that the issuer is a very small company. The bookkeeper of the company did not possess the technical ability to properly prepare a statement of cash flow, the footnotes, or the schedule of deferred tax assets and liabilities for the entity. Therefore, upon completion of the audit, I prepared the statement of cash flows, the footnotes and the schedule of deferred tax assets and liabilities based on the corrected financial statements after the audit adjustments. I realize that this is "technically" correct. However, since there was no one else to prepare the statement of cash flows, and we prepare the companies corporate income tax returns, the alternative was to issue an adverse opinion. When I discussed this with the inspection team, they acknowledged that this scenario was the norm in small audits as opposed to the exception. The inspection team stated that they have often done the same thing when they were in public practice. I feel that the assertion that "our system of quality control appears not to provide reasonable assurance that the Firm will comply with independence requirements" a bit harsh. The statement that we lack independence indicates to the uninformed reader that we are somehow involved with management decisions, that we are a stockholder of the company or that we perform other services with respect to this client, such as bookkeeping services, HR consulting, computer consulting or other prohibited services when a firm is the auditor. We did nothing more than take the facts as a result of the audit and the preparation of the income tax return, and put them in an acceptable format so that we could issue an unqualified opinion, which is what the audit results concluded.

During the subsequent year, the client hired a CPA to be their controller. The CPA has the technical skills to perform the aforementioned tasks, and for the year ended September 30, 2005, we did not prepare the statement of cash flows, footnotes or schedule of tax assets and liabilities.

I believe I have addressed all of the issues as outlined in the draft report of the inspection. This response is in response to Part I of the Inspection Report in its entirety, and should be made a part of any public disclosure of the inspection report.

Sincerely,

Donald L. Moorhead

Donald L. Moorhead
President
Shapley, Shapley & Moorhead, P.C.