PCAOB
Public Company Accounting Oversight Board

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Inspection of Pattillo, Brown & Hill, L.L.P.

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

PCAOB RELEASE NO. 104-2006-195A
(Includes portions of Part II of the full report that
were not included in PCAOB Release No. 104-2006-195)

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 PATTILLO, BROWN & HILL, L.L.P.

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Pattillo, Brown & Hill, L.L.P. ("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 19, 2005 to September 30, 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	5 (Waco, Hillsboro, Brownsville, and Temple, Texas; Albuquerque, New Mexico)
Ownership structure	Limited liability partnership
Number of partners	10
Number of professional staff[3/]	30
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.

[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.

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 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 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 –

[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.

(1) the failure to perform adequate procedures to test the reserve for indemnifications and early payment default losses;

(2) the failure to perform adequate procedures to evaluate a significant fourth quarter adjustment to the reserve for indemnifications and early payment default losses; and

(3) the failure to perform adequate procedures to evaluate assets held for sale and discontinued operations.

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

* * * *

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 a 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.

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 deficiencies 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.

* * * *

[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.

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.

PB&H

PATTILLO, BROWN & HILL, L.L.P.
CERTIFIED PUBLIC ACCOUNTANTS ■ BUSINESS CONSULTANTS

February 23, 2006

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

ATTENTION: GEORGE H. DIACONT, DIRECTOR
DIVISION OF REGISTRATION AND INSPECTIONS

Dear Mr. Diacont:

As you know, the PCAOB conducted an inspection of Pattillo, Brown, & Hill, L.L.P. in September 2005. The PCAOB has also issued a draft report of findings on January 25, 2006, and has allowed our Firm the opportunity to respond. Without commenting further on this point, in the future, I would suggest that your organization, out of respect and understanding for the timing of work in our profession, alter their response demands during this period of the year.

In any event, we strongly disagree with the findings in your report. On the first point, Item A. (1), your audit team seemed intent on finding a "cookie-cutter" approach to our auditing of loan loss reserves and then was critical that "cookie jar" reserves did not exist preventing a wide variation in reserves upon the determination that economic events evaluated in our audit had occurred warranting substantial increases in the reserve. In order to be complete, our response must be segregated into separate areas. First, nature of the inspection.

Nature of the Inspection

It is important to note that the inspection was undertaken off-site; accordingly, copies of work papers were reviewed and contact was primarily by phone or email. The inspection was undertaken by and who indicated they worked together in the Dallas area office. coordinated most of the very limited contact we had, including coordination of * our telephone conference on or about the morning of September 30, 2005. Immediately prior to that teleconference, a draft of their comments was emailed to our attention. This report contained inaccuracies and was based on erroneous conclusions about the nature of schedules included in the work papers concerning sources of information, the author of schedules (prepared by client v. prepared by auditor) and the nature of the client's business. began our teleconference * by stating something similar to you have received our report and these items have been discussed with you during our work; do you have any problems with them and are you ready to agree with these comments? Our answer was "yes, we discussed with the information in the * discontinued operation point; however, we have never had a discussion with anyone about the loan reserve audit procedures, documentation issues or any suggestion points."

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* As a matter of policy, the PCAOB redacts from firms' responses to draft inspection reports the names of PCAOB staff, other than senior staff to whom a response letter is addressed.

* then, although he affirmed we had never had a discussion, became very defensive and aggressive. Throughout our conversation, it became clear that:

1. He did not fully understand the client's business, for example, the client does not retain servicing rights, therefore, no loan files are on-site or in their possession or ownership for review;

2. He did not understand loan payment information, etc., is not on-site, and is unavailable unless provided by the acquiring entity;

3. He did not understand the author of the schedules (copies of schedules) he was reviewing, for example, he criticized us for our lack of verification of information on schedules we prepared, erroneously assuming the schedules were client schedules;

4. He did not understand that the reserve calculation was our independent calculation, not the client's;

5. He ignored the increase in the reserve proposed by us and recorded by the client of $1,616,210, instead, stating that it appeared that we just rubber-stamped the client's reserve at year-end without testing; and

6. His "pride of authorship" would not allow him to admit error.

In short, we disagreed with the comments he made and that the reserve should be based only on historical experience, thereby ignoring changes in circumstances and the environment. Your inspectors then requested we provide a memo explaining certain items. Several weeks later, we were again contacted by the team members indicating they had another draft of comments and would like to drive the 100 miles or so to discuss these face to face. We agreed, and requested a copy of the comments be emailed to us prior to our meeting so we might have read and review them prior to
* our discussion. said definitely not. When asked why, he angrily responded:

1. It is unnecessary;
2. You do not need it;
3. It serves no purpose;
4. It is not yet completed; and
5. Just no.

Believing that the items would surely be finished before they began their two hours drive to our office, we felt this to be unreasonable. This is, however, evidence as to how unprofessional,
* stubborn, and close-minded behaved. His "pride of authorship" and "stubbornness" in this instance is mentioned solely as a verifiable instance of your inspectors' lack of professionalism, lack of desire for the truth v. preconceived conclusions, and general close-minded behavior.
* Eventually, his superior , agreed that our request was not unreasonable and forwarded a copy of the draft comment form on Thursday, October 20, 2005, shortly before our meeting with
*

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It was clear upon their arrival that Mr. was yearning for confrontation. , as he was in all our dealings, was very professional and reasonable. We did not always agree with Mr. but, at least, understood "where he was coming from" and the basis for his conclusions. No questions were asked by the inspectors about the work performed during their meeting and no description of information was ever solicited. Believing there was nothing to be gained from a confrontation, we had no discussion about the validity of the points. * *

Now, a discussion of the invalidity of certain points:

Item A. (1):

In Item A. (1), you state "those deficiencies included "the failure to perform adequate procedures to test the reserve for indemnifications and early payment default losses."

First, before we discuss our specific disappointment with your comments, we would like for you to remember that this was an off-site review and that these comments, or comments roughly identical, were drafted prior to any questions being asked about our work for explanations and prior to any discussions of these matters with any representatives of our Firm. The initial draft was emailed shortly before a telephone conference to discuss. Also, during our telephone conversation, the individual assigned for the review of the audit procedures used in evaluating the reserve clearly did not understand the nature of the client's company. Our disagreements here are based on the following:

1. An increase in the reserve of $1,616,210 was proposed by us and recorded by the client as a result of our testing.

2. A detail review of the adequacy and appropriation of the reserves was performed by us. Such testing included (work papers are included in a separate letter):

    a. Review of historical data;
    b. Review of customer contracts for loan procedures;
    c. Evaluation of controls over such procedures;
    d. Review of interest rate trends;
    e. Review and evaluation of industry trends;
    f. Review of inherent rates and economy trends;
    g. Discussions with other practitioners, primarily through the Community Bank Advisory National "CBAN"; and
    h. Review and evaluation of the possibility of successful E & O and fidelity bond claims.

3. This audit has been reviewed at least five times, possibly more, by two different firms and four different reviewers as part of our AICPA Peer Review Program without an issue or comment on the appropriateness of our audit procedures.

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4. The second or concurring partner on the engagement is a former banker and currently the primary instructor for Texas Bankers Association audits and compliance schools. The partner in charge of the engagement has over 25 years audit experience and two years experience with a bank holding company. The manager on the job has four years big four experience, experience as a chief financial officer and three years experience as an auditor with our Firm, first as a senior, then a manager. The senior on the engagement, also a CPA, has 10 years experience as a loan and compliance officer with a financial institution and four years audit experience.

5. The appropriate audit procedures of the reserve for losses on loans have been a debate for years. Many different organizations have broached this subject without results and, although certain procedures are expected, there is no "cookie-cutter" approved method. The SEC has been critical of reserves recorded without substantiation in an effort to smooth earnings, and the Financial Accounting Standards Board has issued a statement prohibiting such reserves.

Item A. (1): (Continued)

This comment ends "... the Firm did not obtain sufficient competent evidential matters to support its opinion on the financial statements. Those differences included ... (2) the failure to perform adequate procedures to evaluate a significant fourth quarter adjustment to the reserves for indemnification and early payment default losses..."

Our disagreement here is:

1. The adjustment was based on the results of our testing and was proposed by us to the client and subsequently recorded.

2. The adjustment was largely due to events occurring at or near year-end, evaluated by our audit team, and required by us prior to our "signing-off" on the formal statement.

We believe common sense can even reason that the client would not agree to the recording of an adjustment, etc. if they did not believe that the procedures we used were based on due care, that we performed adequate testing of the amounts, and that we possessed convincing information that the reserve required adjustment.

Item A. (3):

Your third comment states that our audit was deficient in "...the failure to perform adequate procedures to evaluate assets held for sale and discontinued operations." This is primarily a difference in professional judgment as to the evaluation of whether the sale of the insurance subsidiary should have been disclosed and presented as discontinued operations. The evaluation was contained in the correspondence file, in a memo from the partner on the engagement to the files and provided to the inspector. A copy was not contained in the audit work papers, but the evaluation had been made. We disagree that the information should be presented as discontinued, for the reasons indicated in our memo and reiterated below:

1. The assets sold were replaced by similar assets after the sale, that is to say liquid assets were sold for liquid assets. The company sold owned assets which were limited to cash and cash equivalent investments. The company was sold for cash. The assets replacing those sold were virtually identical in nature and amount to those sold.

2. Even though the insurance company is being sold, the primary income producing activity historically performed in the operations of that company will be continued. The primary income producing activity, the generation of commissions on the sale of insurance products to mortgage customers will be continued. What is really being sold is a primarily dormant shell which is licensed to underwrite insurance, but which has been primarily dormant and inactive. Of the minimal risk incurred by the company, substantially all of that has been reinsured, and

3. There will be virtually no change to the company structure or operations as a result of this transaction. No personnel worked directly for this entity and First Financial Corp. will continue to generate commission income.

4. Net assets changed less than 1%, revenue by less than 10% and net income less than 3.5%.

These were the reasons for the presentation as it existed at year-end and continue to be our reasons for our choice in presentation.

All items in Part II and III of your report are based on these inspection errors. We will provide selected work papers as attachments to a separate letter. You will find these work papers support our assertions.

Pattillo, Brown & Hill, L.L.P.

By: B. Steven Bostick