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Report on
2009 Inspection of MaloneBailey, LLP
(Headquartered in Houston, Texas)

Issued by the
Public Company Accounting Oversight Board

February 24, 2011

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. 104-2011-082



Preface to Reports Concerning Annually Inspected Firms

The Sarbanes-Oxley Act of 2002 requires the Public Company Accounting Oversight Board ("PCAOB" or "the Board") to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers. The Board's report on any such inspection includes this preface to provide context for information in the public portion of the report.

A Board inspection includes, among other things, a review of selected audits of financial statements and of internal control over financial reporting. If the Board inspection team identifies deficiencies in those audits, it alerts the firm to the deficiencies during the inspection process. Deficiencies that exceed a certain significance threshold are also summarized in the public portion of the Board's inspection report. The Board encourages readers to bear in mind two points concerning those reported deficiencies.

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm's present ability to support its previously expressed audit opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take, action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Second, the Board cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

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 U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure 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 or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



2009 INSPECTION OF MALONEBAILEY, LLP

In 2009, the Board conducted an inspection of the registered public accounting firm MaloneBailey, LLP ("Malone" or "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, Appendix A, and portions of Appendix B. Appendix A provides an overview of the inspection process. Appendix B includes 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 routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement 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 primary procedures for the inspection from September 14, 2009 to September 25, 2009. The inspection team performed field work at the Firm's office, which is located in Houston, Texas.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.^{3/} 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. Appendix A to this report provides a description of the steps the inspection team took with respect to the review of audits and the review of certain firm-wide quality control processes.

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.^{4/} 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 or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

^{3/} This focus necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

^{4/} 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's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

A. Review of Audit Engagements

The inspection procedures included reviews of aspects of 11 audits performed by the Firm. The scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope.

In reviewing the audits, the inspection team identified matters that it considered to be audit deficiencies.^{5/} Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, the conclusion that the Firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3") provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence.^{6/} For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions,^{7/} and failure to take such actions could be a basis for Board disciplinary sanctions.

^{5/} The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process.

^{6/} See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28.

^{7/} See AU 390, *Consideration of Omitted Procedures After the Report Date*, AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*

In some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. The deficiencies that reached this degree of significance are described below.

Issuer A

The Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. The issuer recognized a significant impairment of oil and gas properties. The issuer did not separately identify the amount of the impairment on the face of the income statement and did not disclose in the notes to the financial statements (1) the amount of the impairment, (2) the facts and circumstances that led to the impairment, and (3) the method used to determine the fair value of the impairment, as required by Statement of Financial Accounting Standard No. 144, *Accounting for the Impairment of Long-Lived Assets*.

Issuer B

The Firm failed to identify a departure from GAAP that it should have identified and addressed before issuing its audit report. Prior to the year under audit, the issuer issued notes along with warrants, both of which were convertible into the issuer's common stock. At the time of issuance, the conversion options associated with the notes were accounted for as an embedded derivative liability, and, as a result, the issuer recorded a debt discount that was amortized over the life of the notes. During both the prior year and the year under audit, the notes were converted to shares of common stock. In accounting for those conversions, the issuer wrote off the embedded derivative and the unamortized debt discount and recorded the resulting charge as a reduction of additional paid-in capital rather than as interest expense, as required by GAAP.^{8/}

(both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T), and PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS No. 5"), ¶ 98.

^{8/} The issuer has restated its financial statements related to this matter.

Inappropriate use of the work of a specialist (two audits)

In two audits, the Firm failed to perform procedures necessary to use the work of specialists and, as a result, the Firm failed to obtain sufficient competent evidential matter to support its audit opinions. Specifically, both issuers retained the services of valuation specialists to assist in the determination of the fair value of certain identifiable intangible assets acquired in the issuers' acquisitions. In both engagements, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested certain of the significant underlying data that the issuers had provided to the specialists. (Issuers B and C)

Issuer D

The issuer acquired two companies during the year under audit, recording significant goodwill. The issuer prepared a goodwill impairment analysis at year end, and concluded that no impairment of goodwill was present. The Firm failed to evaluate the reasonableness of the significant assumptions and test the underlying data that the issuer used in its goodwill impairment analysis.

Issuer E

In this audit, the Firm failed in the following respects to obtain sufficient competent evidential matter to support its audit opinion –

- The Firm failed to perform sufficient audit procedures with regard to (1) the existence and valuation of debt, debt discounts, and deferred financing costs, (2) the valuation of a realized gain on derivatives, (3) the valuation of the asset retirement obligation, and (4) the accuracy of the depletion, depreciation, and amortization expense recognized on oil and gas properties.
- The Firm identified proposed adjustments that were waived and evaluated those waived adjustments' effect on the issuer's financial statements. In its evaluation of these waived adjustments, however, the Firm used financial statement totals that did not agree to the issuer's financial statements. The Firm also failed to include in its evaluation a specific waived adjustment that exceeded the Firm's threshold for individually significant items.

Issuer F

Substantially all of the issuer's revenue related to new hosting and development arrangements for the year under audit was based on the terms of individual contracts that included multiple deliverables. To evaluate the fair value assigned to one of the deliverables, the Firm considered the amount charged by three of the issuer's competitors for a similar service, which resulted in a wide range of amounts. The Firm failed to evaluate and assess the issuer's own evidence as to the fair value of this service from the issuer's renewal contracts, which was significantly different from the competitors' amounts.

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 and the following eight areas (1) tone at the top; (2) practices for partner evaluation, compensation, admission, assignment of responsibilities, and disciplinary actions; (3) independence implications of non-audit services; business ventures, alliances, and arrangements; personal financial interests; and commissions and contingent fees; (4) practices for client acceptance and retention; (5) practices for consultations on accounting, auditing, and SEC matters; (6) the Firm's internal inspection program; (7) practices for establishment and communication of audit policies, procedures, and methodologies, including training; and (8) the Firm's policies and practices related to professional development, including continuing professional education for its personnel. 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

APPENDIX A

THE INSPECTION PROCESS

The inspection process was designed and performed to provide a basis for assessing the degree of compliance of the Firm with applicable requirements related to auditing issuers. This process included reviews of components of selected issuer audits completed by the Firm. These reviews were intended both to identify deficiencies, if any, in those components of the audits and to determine whether the results of those reviews indicated deficiencies in the design or operation of the Firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain functional areas of the Firm that could be expected to influence audit quality.

1. Review of Selected Audits

The inspection team reviewed aspects of selected audits of financial statements and ICFR, which it chose according to the Board's criteria. The Firm was not allowed an opportunity to limit or influence the engagement selection process or any other aspect of the review.

For each audit engagement selected, the inspection team reviewed the issuer's financial statements and certain SEC filings. The inspection team selected certain higher-risk areas for review and inspected the engagement team's work papers and interviewed engagement personnel regarding those areas. The areas subject to review included, but were not limited to, revenue, oil and gas properties, derivatives, convertible debt, acquisitions, goodwill and intangibles, and consideration of fraud. The inspection team also analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. For the selected engagements, the inspection team also reviewed written communications between the Firm and the issuer's audit committee. With respect to certain engagements, the inspection also interviewed a member of the issuer's audit committee. When the inspection team identified a potential issue, it discussed the issue with members of the engagement team. If the inspection team was unable to resolve the issue through this discussion and any review of additional work papers or other documentation, the inspection team issued a comment form on the matter and the Firm provided a written response to the comment form.

2. Review of Eight Functional Areas

The inspection team reviewed the eight functional areas both to identify possible defects in the Firm's system of quality control and, where applicable, to update the Board's knowledge of the Firm's policies and procedures in the functional areas.

a. Review of Practices for Partner Evaluation, Compensation, Admission, Assignment of Responsibilities, and Disciplinary Actions

The objective of the inspection procedures was to assess whether the design and application of the Firm's processes related to partner evaluation, compensation, admission, assignment, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as compared to marketing or other activities of the Firm. The inspection team interviewed members of the Firm's leadership regarding these topics. In addition, the inspection team reviewed a sample of partners' personnel files.

b. Review of Independence Implications of Non-Audit Services; Business Ventures, Alliances, and Arrangements; Personal Financial Interests; and Commissions and Contingent Fees

The objective of the inspection procedures in this area was to evaluate the Firm's policies and procedures for compliance with the independence requirements applicable to its audits of issuers. To accomplish this objective, the inspection team reviewed the Firm's policies, procedures, and guidance; reviewed the Firm's monitoring of compliance with its policies and procedures; interviewed Firm leadership regarding the Firm's independence policies, practices, and procedures; and for a sample of the engagements reviewed, tested compliance with the Firm's policies and applicable independence requirements.

c. Review of Practices for Client Acceptance and Retention

The objectives of the inspection procedures in this area were to evaluate whether the Firm appropriately considers and addresses the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the inspection team reviewed the Firm's policies, procedures, and forms related to client acceptance and continuance; interviewed members of the Firm's leadership; and for a sample of the engagements reviewed, assessed whether the audit procedures included

the specific actions, if any, contemplated in response to any risks identified in the client acceptance or retention process.

d. Review of Practices for Consultations on Accounting, Auditing, and SEC Matters

The objective of the inspection procedures in this area was to assess the effectiveness of the Firm's consultation process. Toward this objective, the inspection team gained an understanding of and evaluated the Firm's policies and procedures relating to its consultation process.

e. Review of the Firm's Internal Inspection Program

The objective of the inspection procedures in this area was to evaluate the effectiveness of the Firm's internal inspection program in enhancing audit quality. To meet this objective, the inspection team reviewed policies, procedures, guidance, and forms; documentation of the results of the current year's internal inspection program; and steps the Firm took in response to those results. The inspection team also interviewed the Firm's leadership concerning the process and effectiveness of its internal inspection program.

f. Review of Practices for Establishment and Communication of Audit Policies, Procedures, and Methodologies, Including Training

The objectives of the inspection procedures in this area were to update the inspection team's understanding of the Firm's processes for establishing and communicating audit policies, procedures, and methodologies and to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance. Toward those objectives, the inspection team reviewed documentation relating to internal guidance and/or training materials distributed to audit personnel with respect to recent changes in requirements and with respect to selected specific areas. The inspection team also evaluated the effectiveness of the design of the Firm's processes for monitoring developments that could affect the Firm's audit policies, procedures, and methodologies.

- g. Review of the Firm's Policies and Practices Related to Professional Development, Including Continuing Professional Education for its Personnel

The objective of the inspection procedures was to evaluate whether the Firm was providing appropriate and adequate training opportunities to its professional staff. To achieve this objective the inspection team reviewed the Firm's policies related to its professional development program, interviewed personnel responsible for assessing and monitoring the professional personnel's compliance with the Firm's training programs, and reviewed the continuing education reports for the partners responsible for the issuers inspected.

- h. Review of Tone at the Top

The objective of the review of the Firm's "tone at the top" was to assess whether actions and communications by the Firm's leadership demonstrate a commitment to audit quality. Toward that end, the inspection team interviewed members of the Firm's leadership to understand their perspectives on the Firm's culture and the messages being conveyed by leadership. In addition, the inspection team reviewed the Firm's code of conduct.

APPENDIX B

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 Firm provided a written response to a draft of this 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.^{9/}

^{9/} In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.

January 24, 2011

Mr. George Diacont
Director
Division of Registration and Inspections
1666 K Street NW
Washington DC 20006-2803

Re: Malone & Bailey P.C.-Response to Part 1 of 2009 Draft Report

Dear Mr. Diacont:

We are pleased to provide our response to the Public Company Accounting Oversight Board's (PCAOB) report on the 2009 inspection of Malone & Bailey P.C. (the report) dated December 22, 2010. We support the PCAOB inspection process to help us identify areas where we may improve our audit performance. We believe the inspection process is a fundamental mission of the PCAOB and intend to use the process to identify areas where we might improve our quality control and enhance audit quality.

The issues raised in the report reflect the fact that accounting and auditing standards are highly complicated and require significant professional judgment in their interpretation and application. Due to this fact, differences of professional opinion may occur with regard to the reasonableness of significant assumptions and evidentiary support. We recognize that professional judgments in both the PCAOB inspection process as well as the performance of an audit may differ. In certain audit circumstances our view as a firm on judgments regarding the materiality of particular issues in the context of the financial statements taken as a whole and the related nature and extent of necessary audit procedures and conclusions may differ from that of the PCAOB. While we are respectful of the position PCAOB has taken in its report we must disagree with the conclusions. We believe that the audit procedures performed and the evidential matter collected were sufficient to support our opinion in all cases cited in the report. More significantly, we believe that our professional interpretation of audit and accounting standards complied with the intent and the letter of the standards.

While we do not agree with the characterizations outlined in the report, we have carefully considered the issues identified. We appreciate the opportunity to respond to the report and look forward to future constructive dialogue.

Sincerely,



Malone & Bailey LLP