



1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

Report on

2010 Inspection of MaloneBailey, LLP (Headquartered in Houston, Texas)

Issued by the

Public Company Accounting Oversight Board

April 5, 2012

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. 104-2012-110

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.

2010 INSPECTION OF MALONEBAILEY, LLP

Preface

In 2010, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm MaloneBailey, LLP ("Malone" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is issuing this report in accordance with the requirements of the Act.^{1/} The Board is releasing to the public Part I of the report and portions of Appendix A. Appendix A includes the Firm's comments, if any, on a draft of the report.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system) is nonpublic, unless the firm fails to make sufficient progress in addressing those criticisms.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm performs audit work.^{3/} To achieve that goal, Board inspections include reviews of certain aspects of selected audit work performed by the firm and reviews of certain aspects of the firm's quality control system. It is not the purpose of an inspection, however, to review all of a firm's audit work 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

^{1/} In its Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004), the Board described its approach to making inspection-related information publicly available consistent with legal restrictions.

^{2/} 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.

^{3/} This focus on weaknesses and deficiencies 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.

audit work, or the relevant issuers' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

If the Board inspection team identifies deficiencies that exceed a certain significance threshold in the audit work it reviews, those deficiencies are summarized in the public portion of the Board's inspection report.^{4/} The Board cautions, however, against extrapolating from the results presented in the public portion of the report to broader conclusions about the frequency of deficiencies throughout the Firm's practice. Audit work is selected for inspection largely on the basis of an analysis of factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

^{4/} Inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. 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 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. The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements. Failure by a firm to take appropriate actions, or a firm's misrepresentations, in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from July 26, 2010 to August 6, 2010. The inspection team performed field work at the Firm's office, which is located in Houston, Texas.

A. Review of Audit Engagements

The 2010 inspection of the Firm included reviews of aspects of 11 audits performed by the Firm. The inspection team selected the audits and aspects to review, and the Firm was not allowed an opportunity to limit or influence the selections.

The inspection team identified matters that it considered to be deficiencies in the performance of the audit work it reviewed. Those 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 was based on the absence of documentation and the absence of persuasive other evidence, even if the Firm claimed to have performed the procedure.^{5/}

One of the deficiencies described below relates to auditing aspects of the issuers' financial statements that the issuer restated after the primary inspection procedures.^{6/}

The inspection team considered certain of the deficiencies that it observed to be audit failures. Specifically, certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial

^{5/} PCAOB Auditing Standard ("AS") No. 3, *Audit Documentation* 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/} The Board inspection process did not include review of any additional audit work related to the restatement.

reporting ("ICFR"). The audit deficiencies that reached this level of significance are described below.^{7/}

Issuer A

During the year, the issuer completed the acquisition of another entity and recorded identifiable intangible assets. The issuer used an outside specialist to value the identifiable intangible assets. The valuation report prepared by the outside specialist included issuer-prepared financial projections for ten years, including forecasts of substantial revenue growth. The specialist indicated in the valuation report that it relied on the financial projections provided by management, with no independent verification of the projections or their underlying assumptions, but that, based on a comparison to rapidly growing companies in the issuer's industry, the issuer's financial forecast was "optimistic." The Firm's procedures to evaluate the reasonableness of the issuer's revenue projections were limited to comparing the first year of the projections to the issuer's budget, comparing amounts to certain existing customer contracts (whose expected revenues totaled well under one-half of the revenues in the first year of the projections), and comparing the revenue growth rate to the historical rates for companies in the issuer's industry, including for periods before 2000. The Firm documented its view that the revenue projections "may be aggressive" and was aware of the specialist's view that the issuer's forecast was optimistic. Nevertheless, the Firm performed no procedures beyond those described above to evaluate the reasonableness of the revenue projections.

Issuer B

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR –

- As a result of its substantive procedures, the Firm identified an error in the issuer's calculation of the charge for the impairment of oil and gas properties and proposed an adjustment to the financial statements, which the issuer recorded. The Firm concluded that the related deficiency in the issuer's control over the reporting of oil and gas assets was a significant deficiency, noting that the control activity had occurred and that the error did not have any effect on cash or cash flows. The Firm failed, however, to perform an appropriate evaluation of the severity of the deficiency.

^{7/} 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.

Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had evaluated the magnitude of potential misstatements resulting from the deficiency.

- The issuer hired a consultant to assess, document, and test its ICFR. The Firm reviewed and evaluated the consultant's planning, scoping, and risk assessment decisions. For multiple controls tested by the consultant, including manual controls and subjective controls, the Firm assessed the risk associated with the controls as high. The Firm also identified several risks of fraud. The Firm used the work of the consultant for testing the design and operating effectiveness of the selected controls over all relevant assertions for all significant accounts and disclosures and over the financial reporting process. The Firm reviewed the consultant's documentation of its tests of controls and re-performed certain of those tests for medium- and high-risk controls. The Firm, however, failed to perform independent testing of any of the controls, including high-risk controls, controls that addressed the risk of fraud or other significant risks, and entity-level controls

Issuer C

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR –

- The year under audit was the first year that the issuer reported on its ICFR, and it hired a consultant to assess, document, and test its ICFR. The Firm reviewed and evaluated the consultant's planning, scoping, and risk assessment decisions. For multiple controls tested by the consultant, including manual controls and subjective controls, the Firm assessed the risk associated with the controls as high. The Firm also identified several risks of fraud. The Firm used the work of the consultant for testing the design and operating effectiveness of the selected controls over all relevant assertions of all significant accounts and disclosures and over the financial reporting process. The Firm reviewed the consultant's documentation of its tests of controls and re-performed certain of those tests for medium- and high-risk controls. The Firm, however, failed to perform independent testing of any of the controls, including high-risk controls, controls that addressed the risk of fraud or other significant risks, and entity-level controls.
- Certain of the controls selected for testing consisted of management review of certain important financial statement inputs, such as production

information and pricing, reserve reports, and depletion calculations. The Firm, however, failed to identify and address that the consultant's testing was not sufficient to conclude on the operating effectiveness of these controls, as the testing consisted of merely verifying that the review had occurred and that the reviewer had the requisite competence and experience. The Firm failed to obtain evidence of the procedures followed during the review, including the level of precision of the review, or its effectiveness.

Issuer D

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the issuer's financial statements –

- The Firm failed to perform sufficient procedures to test the issuer's recognition of revenue. The Firm selected a sample of sales transactions and, for that sample, used information in the issuer's internal database to determine whether services had been completed, which was a condition for the recognition of revenue. In addition, the Firm's revenue cutoff procedures consisted of tracing certain information, for a sample of sales transactions for the last month of the year and the first month of the subsequent year, from the issuer's detailed revenue ledger to the issuer's internal database. The Firm, however, failed to test the accuracy of the information in the issuer's internal database that it used in its procedures.
- The Firm failed to perform sufficient procedures to test the existence of accounts receivable at year end, as the Firm's testing was focused on the accounts receivable at an interim date, without sufficient procedures to extend its conclusions to year end. The Firm did not confirm accounts receivable due to the ineffective results obtained from confirmations sent in the prior year, and did not rely on internal control. The Firm's testing of the existence of accounts receivable at the end of the third quarter consisted of tracing subsequent cash receipts for certain accounts receivable, and comparing certain information regarding sales in the first three quarters of the year to customer contracts. The Firm's procedures with respect to accounts receivable at year end were limited to comparing the accounts receivable balances to those for the prior three years (which showed that the accounts receivable balance approximately doubled over the balance in the prior year), testing the mathematical accuracy of the accounts receivable aging schedule, and scanning that schedule for unusual balances.

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

PARTS II AND III OF THIS REPORT ARE NONPUBLIC
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

APPENDIX A

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.^{8/}

^{8/} 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.

March 20, 2012

Ms. Helen Munter
Director
Division of Registration and Inspections
1666 K Street NW, suite 800
Washington, DC 20006

Re: Response to Part I of the Draft Report on the 2010 Inspection of MaloneBailey LLP

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board's ("PCAOB") report on the 2010 inspection of MaloneBailey LLP dated March 2, 2012 (the "Draft Report"). 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 should improve and enhance our audit quality.

We have evaluated each of the matters described in Part I of the Draft Report. In that regard, we have considered whether it was necessary to perform additional procedures in accordance with 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* and, where appropriate, performed such procedures.

We remain committed to improving our audit performance and underlying quality control systems. We appreciate the opportunity to respond to the report and look forward to future constructive dialogue.

Sincerely,

MaloneBailey, LLP

Malone Bailey LLP