

Report on
2011 Inspection of MaloneBailey, LLP
(Headquartered in Houston, Texas)

Issued by the
Public Company Accounting Oversight Board
October 1, 2013

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PORTIONS OF THE COMPLETE REPORT ARE OMITTED
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SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The 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 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 financial statement misstatements, including failures to comply with 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 apparent misstatements 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 whether an issuer's financial statements are misstated or fail to comply with Commission disclosure requirements, rests with the Commission. Any description, in this report, of financial statement misstatements or failures to comply with 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.

2011 INSPECTION OF MALONEBAILEY, LLP

Preface

In 2011, 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.^{2/} Appendix A includes the Firm's comments, if any, on a draft of the report.^{3/} 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 conducts audits.^{4/} To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of certain aspects of the firm's quality control system. It is not the purpose

^{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 Act requires the Board to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 issuers.

^{3/} 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.

^{4/} 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.

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 the relevant issuer's 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 audits it reviews, those deficiencies are summarized in the public portion of the Board's inspection report.^{5/} 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. Audits are 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.

^{5/} 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 staff ("the inspection team") conducted primary procedures for the inspection from June 6, 2011 through June 16, 2011. The inspection team performed field work at the Firm's headquarters office in Houston, Texas.

A. Review of Audit Engagements

The 2011 inspection of the Firm included reviews of aspects of 12 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 work it reviewed. Those deficiencies included failures by the Firm to identify, or to address appropriately, financial statement misstatements, as well as 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.^{6/}

One of the identified deficiencies was 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. The audit deficiency that reached this level of significance is described below.^{7/}

^{6/} PCAOB Auditing Standard 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.

^{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.

Issuer A

In a year prior to the year under audit, in connection with the issuer's sale of a participating interest in a venture, the issuer (1) paid cash and (2) agreed to issue shares of its common stock and warrants to purchase its common stock to an outside party as compensation for arranging the sale. The common stock and warrants were valued and expensed in a prior year, and were made available for issuance by the issuer, although the outside party did not provide the issuer with the required documentation necessary for issuance. During the year under audit, the outside party provided the required documentation for the issuance of the securities and the issuer issued the common stock and warrants. The warrant agreement, as originally drafted for issuance, however, contained an expiration date that was earlier than the ultimate issuance date. Consequently, upon issuance of the warrants, the issuer extended the life of the warrants for an additional four years. The issuer determined that the extension of the warrant term did not represent a modification, and as such, no incremental expense was recorded.

The Firm's audit work papers included the warrant extension agreement, testing of the fair value of the warrants at the date of extension, and the Firm's conclusion that the extension of the warrant term for an additional four years was not a modification and consequently no incremental warrant expense was recorded by the issuer.

The incremental fair value of the warrants, as determined by comparing the issuer-estimated warrant fair value immediately after the extension with the fair value immediately before the extension, would have increased the issuer's net loss by approximately 22 percent if the issuer had recorded the incremental fair value. Financial Accounting Standards Board Accounting Standards Codification Topic 718, *Compensation – Stock Compensation*, requires the recognition of such incremental fair value as compensation expense. The Firm inappropriately accepted the issuer's accounting for the extension of the warrant term and should have identified and addressed this departure from GAAP in the issuer's financial statements.

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 five areas (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining clients; and (4)

the Firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to weaknesses in quality control. 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.



August 14, 2013

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 2011 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 2011 inspection of MaloneBailey LLP dated July 12, 2013 (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. With respect to the deficiency noted for Issuer A, please find our response included herein at Appendix A.

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,

Malone Bailey, LLP

Malone Bailey LLP

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Appendix A

Regarding the Board's summary of Issuer A, our firm believes the report is not forthcoming regarding the facts. The report says the warrants were made available for issuance by the issuer. The warrants in question were held in suspense during the original term due to a dispute between the holder and the issuer that initiated after the grant. This fact must be considered when evaluating whether or not the extension of the term was a modification. While in suspense, the warrants could not be exercised by the holder. The warrants were in effect shelved during the dispute period and taken out of suspense upon resolution of the dispute. At the time of resolution the original legal term of the warrants had lapsed. Legally, the warrants were expired at the resolution date. The agreement between the parties at the resolution date was to effectively restore the holder to their original position regarding the common shares and the warrants. In the case of the shares, the shares were issued. In the case of the warrants, given the legal expiration, the issuer restored the original length of term to cure the expiration.

The issuer and MaloneBailey LLP considered whether or not the restoration of the original length of term was a modification. The essence of a modification would typically be to provide a benefit to the holder. Under typical facts and circumstances where a warrant is freely exercisable and the holder does not exercise during the original term and the issuer were to extend the term as an inducement to exercise, such an extension would be a benefit to the holder. The facts and circumstances in this transaction are not typical and therefore warranted further consideration. The issuer and MaloneBailey LLP separately determined that the substance of the restoration was not to give any benefit to the holder but was instead designed and intended to restore the holder to their original position prior to the dispute. Had the issuer reduced the exercise price or given a term in years different than the original term, such as twice the term length, those facts would have resulted in a different conclusion as they would have been considered to be a benefit to the holder designed to induce exercise. Restoring the original term is not a benefit to the holder, it was a correction to a legal expiration brought on by the dispute and ultimately meant to take the warrants out of suspense making them eligible for exercise.

Furthermore, we believe it is important to consider that when the original warrants were granted prior to the dispute, the warrants were valued and expensed in the amount of approximately \$5M when granted. At that time, the warrants were substantially in the money resulting in the high expense. At the date of restoration, the warrants with all of the same terms as the original were valued at only \$1.4 Million. At the restoration date the value was much lower due to the warrants being out of the money. We believe this important as it further illustrates the issuer in restoring the term was not attempting to give a benefit to the holder. Had a benefit been the intention, the issuer would have reduced the exercise price to put them in the money but this did not happen, the only change that occurred regarding the warrants was restoration of the original term which was legally required considering the expiration during the dispute and suspended period.

Lastly, the report notes had the incremental value been recorded it would have increased the issuer's net loss by approximately 22%. This statement is misleading as it doesn't make clear that the issuer has no revenues and was at the year under audit in the development stage. Given the issuer was in the development stage with no revenues and only losses, the additional non cash expense would not have been considered material under SEC's definition of materiality which in SAB Topic 1N refers to Concept Statement 2 defining materiality as "it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item". A reasonable person relying upon the report would not have found a non cash expense on a \$0 revenue development stage company material, they would have considered the disclosure regarding potential dilution to be material for which the potential dilution was clearly disclosed for the users of report.