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Report on

2012 Inspection of MaloneBailey, LLP

(Headquartered in Houston, Texas)

Issued by the

Public Company Accounting Oversight Board

October 1, 2013

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. 104-2013-219

2012 INSPECTION OF MALONEBAILEY, LLP

Preface

In 2012, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm MaloneBailey, LLP ("MaloneBailey" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").[1/]

The inspection process is designed, and inspections are performed, to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. The inspection process included reviews of aspects of selected issuer audits completed by the Firm. The reviews were intended to identify whether deficiencies existed in those aspects of the audits, and whether such deficiencies indicated defects in the Firm's system of quality control over audits. In addition, the inspection included reviews of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The issuer audits and aspects of those audits inspected were selected based on a number of risk-related and other factors. Due to the selection process, the deficiencies included in this report are not necessarily representative of the Firm's issuer audit practice.

The Board is issuing this report in accordance with the requirements of the Act.[2/] The Board is releasing to the public Part I of the report and portions of Appendix B. Appendix B includes the Firm's comments, if any, on a draft of the report. 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.

[1/] 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.

[2/] 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.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures for the inspection from July 9, 2012 through July 13, 2012 and July 23, 2012 through July 27, 2012. The inspection team performed field work at the Firm's headquarters office in Houston, Texas.

A. Review of Audit Engagements

The 2012 inspection of the Firm included a review of aspects of 10 audits performed by the Firm. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The inspection team considered certain of the deficiencies that it observed to be audit failures. As used in PCAOB inspection reports, the term "audit failure" refers to a circumstance where the inspection team identified one or more deficiencies in an audit that 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 reporting ("ICFR"). The audit deficiencies that reached these levels of significance are described below.[3/]

1. Issuer A

The Firm issued an unqualified opinion on the effectiveness of the issuer's ICFR. The issuer reported unproved oil and gas properties that represented approximately 13 percent of total assets as of the end of the year under audit. The issuer also reported an impairment of unproved oil and gas properties for the year under audit that equaled approximately 81 percent of the net loss for the year. The Firm failed to identify and test the operating effectiveness of controls over the development of the impairment of unproved oil and gas properties.

[3/] 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. In addition, 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 for purposes of imposing legal liability.

2. Issuer B

Approximately 43 percent of the issuer's revenue was recognized on fixed-price contracts using the percentage-of-completion method, measured by the percentage of costs incurred to date to estimated costs for each contract. Approximately eight percent of the issuer's revenue was recognized from contracts in progress at year end. The Firm tested revenue recognition by obtaining an issuer-prepared schedule of contracts in progress at year end, which included the percentage of completion for each contract, and (1) mathematically verified the clerical accuracy of the schedule; (2) for selected contracts, compared the contract cost on the schedule to the customer's purchase order; and (3) for selected contracts, compared actual costs incurred to date as reported on the schedule to supporting documentation. The Firm failed to perform sufficient procedures to test revenue recognition under the percentage-of-completion method. Specifically, the Firm failed to test the reasonableness of the issuer's estimated costs-to-complete on the contracts in progress at year end.

3. Issuer C

For the year under audit, the issuer's revenue increased approximately 103 percent from the prior year. The Firm identified improper revenue recognition and management override of controls as both significant risks and fraud risks. To test revenue recognition, the Firm (1) carried forward a memorandum from the prior year audit that documented the issuer's revenue recognition policy; (2) judgmentally selected 12 transactions from the issuer's general ledger, which represented approximately one percent of the issuer's revenue for the year, and compared those transactions to supporting invoices, shipping documents, and subsequent collections documentation; (3) judgmentally selected five sales transactions for both the last day of the year under audit and the beginning of the issuer's subsequent year and compared those transactions to supporting invoices and shipping documents; and (4) performed confirmation or alternative procedures to test a sample of accounts receivable balances that equaled approximately 10 percent of revenue for the year under audit. The Firm failed in determining the sample size to consider appropriate factors – including its established tolerable misstatement; the allowable risk of incorrect acceptance based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests; and the characteristics of the population, including the expected size and frequency of misstatements – and the resulting sample size was too small to achieve the planned objective.

B. Auditing Standards

Each of the deficiencies described in Part I.A of this report represents circumstances in which the Firm failed to comply with the requirement to obtain sufficient appropriate evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with applicable accounting principles, and/or for its opinion concerning whether the issuer maintained, in all material respects, effective internal control over financial reporting. Each deficiency relates to several applicable standards that govern the conduct of audits.

AU 230, *Due Professional Care in the Performance of Work* ("AU 230") requires the independent auditor to plan and perform his or her work with due professional care. AU 230 and Auditing Standard ("AS") No. 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS No. 13") specify that due professional care includes the exercise of professional skepticism. This is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13 requires the auditor to design and implement audit responses that address the identified risks of material misstatement, and AS No. 15, *Audit Evidence* ("AS No. 15") requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in support of the related conclusions.

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS No. 5") and AS No. 13 establish requirements regarding testing and evaluating internal control over financial reporting. In an audit of internal control over financial reporting in an integrated audit, AS No. 5 requires the auditor to plan and perform the audit to obtain appropriate evidence that is sufficient to support the auditor's opinion on internal control over financial reporting as of the date of that opinion. AS No. 13 requires that, if the auditor plans to assess control risk at less than the maximum and to base the nature, timing, and extent of substantive audit procedures on that lower assessment, the auditor must obtain evidence that the controls tested were designed and operating effectively during the entire period for which the auditor plans to rely on controls to modify the substantive procedures.

The deficiencies described in Part I.A of this report relate to one or more of the provisions referenced above, and in many cases also relate to the failure to perform, or to perform sufficiently, certain specific audit procedures that are required by other applicable auditing standards. The table below lists the specific auditing standards that are primarily implicated by the deficiencies identified in Part I.A. of this report. The broadly applicable aspects of AS No. 5, AS No. 13, AS No. 15, and AU 230 discussed above are not repeated in the table below.[4/]

PCAOB Auditing Standards	Issuers
AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*	A
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	B
AU Section 350, *Audit Sampling*	C

C. General Information Concerning PCAOB Inspections

Board inspections are designed to identify whether weaknesses and deficiencies exist related to how a firm conducts audits and to address any such weaknesses and deficiencies. To achieve that goal, 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. The 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. Further, the inclusion in an inspection report of certain deficiencies and potential deficiencies should not be construed as an indication that the Board has made any determination about other aspects of the firm's systems, policies, procedures, practices, or conduct not included within the report.

The inspection team selects the audits and aspects to review, and the Firm is not allowed an opportunity to limit or influence the selections. In the course of reviewing aspects of selected audits, the inspection team may identify matters that it considers to be deficiencies in the performance of the work it reviews. Those deficiencies may include failures by the Firm to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[5/] as well as

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[4/] This table does not necessarily include reference to every auditing standard that may have been implicated by the deficiencies included in Part I.A.

[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 applicable accounting principles, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures. 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 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. 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.

In some cases, the conclusion that a 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 claimed to have performed the procedure. AS 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.

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 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.[6/]

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determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

[6/] The inspection team may review, either in the same inspection or in subsequent inspections, the adequacy of the firm's compliance with these requirements.

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 processes related to audit quality. This review addressed practices, policies, and procedures concerning audit performance and the following four 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, including the application of the Firm's risk-rating system; 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.

END OF PART I

PART II, PART III, AND APPENDIX A OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

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.[7/]

[7/] 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.

malonebailey LLP
CERTIFIED PUBLIC ACCOUNTING FIRM

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 2012 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 2012 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 Fasts 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