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Public Company Accounting Oversight Board

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Report on

2013 Inspection of Habif, Arogeti & Wynne, LLP

(Headquartered in Atlanta, Georgia)

Issued by the

Public Company Accounting Oversight Board

June 26, 2014

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. 104-2014-150

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2013 INSPECTION OF HABIF, AROGETI & WYNNE, LLP

In 2013, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Habif, Arogeti & Wynne, LLP ("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 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 inspected firm. The reviews were intended to identify whether deficiencies existed in those aspects of the audits, and whether such deficiencies indicated weaknesses or 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 audit and aspects of that audit 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 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]

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[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. As described there, if the nonpublic portions of any inspection report discuss criticisms of or potential defects in a firm's system of quality control, those discussions also could eventually be made public, but only to the extent a firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from June 3, 2013 to June 6, 2013. These procedures were 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	2 (Sarasota, Florida and Atlanta, Georgia)
Ownership structure	Limited liability partnership
Number of partners	27
Number of professional staff[2]	206
Number of issuer audit clients[3]	3

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[2] "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.

[3] 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. For information about audit reports issued by the Firm, see Item 4.1 of the Firm's annual reports on PCAOB Form 2, available at www.pcaobus.org.

A. Review of Audit Engagement

The inspection procedures included a review of aspects of the Firm's auditing of financial statements of one issuer. The inspection team identified what it considered to be audit deficiencies. The deficiencies identified in the audit reviewed included a deficiency 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 appropriate audit evidence to support its opinion on the issuer's financial statements. That deficiency was –

Issuer A

> the failure to perform sufficient procedures to test the occurrence, completeness, and valuation of revenue, including the inadequate performance of substantive analytical procedures.

B. Auditing Standards

The deficiency described in Part I.A of this report represents circumstances in which it appeared to the inspection team that the Firm failed to comply with the requirement to obtain sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with applicable accounting principles. The 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 PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS No. 13"), specify that due professional care requires 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 PCAOB Auditing Standard 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.

The deficiency described in Part I.A of this report involves, in the inspection team's view, a failure to comply with the provisions cited above and also a failure to perform, or perform sufficiently, certain specific audit procedures that are required by other applicable auditing standards. The table below lists the other specific auditing standard that is primarily implicated by the deficiency identified in Part I.A of this report.[4]

PCAOB Auditing Standard	Issuer
AU 329, *Substantive Analytical Procedures*	A

C. 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. 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.

D. General Information Concerning PCAOB Inspections

Board inspections are designed to identify whether weaknesses and deficiencies exist related to how a firm conducts audits and addresses any such weaknesses and deficiencies. 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. The scope of the inspection procedures is determined according to the Board's criteria, and the firm is not allowed an opportunity to limit or influence the scope. The focus on weaknesses and deficiencies necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not

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

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.

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 Generally Accepted Accounting Principles ("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 or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

In some cases, an inspection team's observation 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 a 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. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a

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[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 "Commission"), which has jurisdiction to 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.

procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of 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. Under PCAOB standards, when audit deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.[6] 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. 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.

END OF PART I

[6] See AU 390, *Consideration of Omitted Procedures After the Report Date,* ("AU 390"), and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU 561") (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T).

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

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 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] The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. 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.

HA&W
HABIF, AROGETI & WYNNE, LLP
Certified Public Accountants and Business Advisors

April 21, 2014

Ms. Helen A. Munter, Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: **PUBLIC RESPONSE** to 2014 Draft Report of Inspection of Habif, Arogeti & Wynne, LLP (the "Firm")

Dear Ms. Munter:

Thank you for the opportunity to submit our Firm's response to the Draft Report of Inspection (the "Draft Report") dated March 20, 2014, and prepared by the Division of Registration and Inspections (the "inspection staff") of the Public Company Accounting Oversight Board ("PCAOB" or the "Board").

We are committed to the highest standards of quality and have designed our quality control policies and procedures to achieve the highest level of assurance and to continually identify opportunities for improvements in audit quality.

As discussed extensively in the paragraphs that follow, we disagree with the conclusions in the Draft Report regarding the failure to sufficiently test the relevant assertions related to revenue, including the use of analytical procedures, and with many of the observations that appear to have led to them. We firmly believe our views and our objections are well supported by the operative auditing standards and by the facts and circumstances. Other violations of auditing standards asserted in Part I of the Draft Report relative to due professional care and audit evidence[1] are indirectly derivative from this alleged deficiency and, therefore, in our view, equally inappropriate. Moreover, the conclusion of inadequate scope of revenue testing is also improperly based on assessing each revenue-related procedure employed individually without considering the corroborative interrelationship of the procedures with respect to the revenue assertions as they relate to the financial statements, taken as a whole, upon which we opined.[2] In addition, in many respects, the scope of the procedures we performed described herein, exceeded those described in the Draft Report.

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1 IAS AU 230 and AS 13.

2 See **Identifying and addressing significant revenue-related assertions**, below.

PUBLIC RESPONSE TO DRAFT REPORT OF INSPECTION

Our risk assessments relative to revenue and their effects on audit scope

As pointed out in Part II of the Draft Report, our planning documentation erroneously characterized the risk of material misstatement as high for existence (and valuation) of revenue (when it should have been moderate) and as moderate for completeness of revenue. However, because of the absence of cash sales transactions, which generally present significant inherent risk relative to revenue completeness, we actually viewed the inherent risk relative to this assertion as low, except as might be manifested in the form of inventory shortages (which we believe was adequately addressed primarily through substantive analytical tests of gross profit margins and by examining physical to perpetual inventory variance adjustments that we determined to be insignificant), and to a lesser extent, underreporting of product royalty revenue by the sole customer that reports usage to the issuer as the basis for recording revenue. We assessed the risk of material understatement of such revenue as insignificant, noting that pursuant to the royalty agreement, management of the issuer performs regular onsite audits of the usage by the customer and has observed no significant variances, which we verified and believe enabled us to rely on a substantive analytical test described below. Accordingly, our preliminary risk assessments relating to existence and completeness of revenue were reduced from our initial assessment. However, we did not update our risk assessment form for this revised assessment, but rather, the conclusion and analysis supporting our revised assessment was documented elsewhere in our file, which was provided to the inspection team in response to the related comment form.

These errors in documenting our preliminary risk assessments were merely ministerial and had no consequence relative to audit scope or the adequacy thereof and, in our opinion, should not affect the overall evaluation of our audit.

Following the guidance in the applicable auditing standard, we began our risk assessment procedures relative to revenue with a presumption of probable fraud risk involving improper revenue recognition in particular regard only to existence (or occurrence).[3] Despite language to the contrary contained in our audit documentation discussed in the foregoing paragraph, we viewed overall inherent risk relative to completeness to be low. Our assessment of low inherent fraud risk relating to the completeness assertion was based, among other factors, on our observations that (a) the issuer had no identifiable motivation to understate its revenue for reporting earnings or to manipulate the stock price, (b) the issuer had significant net operating losses, and (c) because of the low level of complexity relating to the nature of the issuer's revenue. On the other hand, poor operating results and maintaining its stock exchange listing and price might have afforded management with a motive to overstate revenue.

3 AS 12.68.

In connection with our evaluation of the various types of revenue or revenue transactions to determine which might present fraud risks relative to existence, we did not identify any significant, specific fraud risk indicators for improper revenue recognition that warranted addressing directly in our audit scope. Specifically, we noted the absence of any evidence of any significant fraud risk opportunities associated with improper revenue recognition, most particularly as to existence, such as the following (among others):

- Sales of merchandise primarily to distributors or other resellers, rather than to end users,
- Sales generally made with liberal rights of return or cancellation provisions,
- Consignment, "in substance" consignment, bartering, bill-and-hold practices, channel stuffing and/or apparent side agreements with customers, and
- Significant new license arrangements with complex multiple-deliverable elements or new customers giving rise to substantial amounts of deferred revenue.

While we noted the absence of significant fraud risk opportunities associated with revenue assertions noted above, we did note, however, the presence of the following factors that might constitute fraud risk incentives and we considered them to the extent we deemed appropriate in determining our audit scope focusing principally on the existence of revenue:[4]

- A high degree of competition,
- Vulnerability to rapid changes in technology, and
- A history of operating losses.

In our risk assessment procedures, including those performed in connection with obtaining an understanding of the entity and its environment, we gained knowledge about the nature of the revenue and the related risk. We identified existence (as described below under **Identifying and addressing significant revenue-related assertions**) as the primary revenue-related inherent risk of material misstatement to be addressed in the audit scope, although we assessed it only at a moderate level. The assessment of risk and extent of undetected misstatement remaining in the unexamined population relies solely on the exercise of considerable auditor judgment.[5] The Draft Report offers no specific rationale in support of the overall conclusion of inadequate audit scope. On the contrary, we remain confident that our judgments in this matter were sound, good faith judgments made by competent professionals based on many hours of thoughtful analysis and years of familiarity with the issuer's business and industry and the environment in which it operates.

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4 See **Identifying and addressing significant revenue-related assertions**, below.

5 See **Professional judgment**, below.

Specifically, our risk assessment relative to revenue included consideration of risk-related factors and performance of analytical planning and other risk assessment procedures listed as follows:

1. We ascertained that there were no new software licenses sold for which revenue was recognized in 2012; the only software license revenue recognized was the ongoing revenue from a very small number of customers and consisted of approximately 1% of total consolidated revenue. Other software related revenue was primarily from existing customers for ongoing maintenance, professional or processing services sold. The fact that there were no new license customers for which any revenue had yet been recognized and that substantially all the other software-related revenue was from recurring customers, and that revenue was relatively predictable and lacking in complexity, we assessed inherent risk of improper revenue recognition for this particular category as low. We further noted that two customers made up approximately 61% of the total software-related revenue.

2. We ascertained that total (unaudited) consolidated revenue remained relatively consistent and was approximately $16,530,000 in 2012, compared to approximately $16,324,000 in 2011.

3. We determined that no new products (equipment) were introduced except for a portable version of an older product.

4. We ascertained that the products being sold were homogenous in nature, and generally consisted of a base product (equipment) with some minor variations, thus further indicative of low complexity of related revenue transactions.

5. We noted that there were no material misstatements relating to revenue identified in the prior year.

6. We reconfirmed that there is only one location for both subsidiaries, and that the accounting function is centralized under the direct supervision of the chief financial officer.

7. We reconfirmed the issuer's continuing policy and practice to bill product sales after shipment has been made, and that it did not require deposits in advance of shipments or offer any right of return. We concluded that the only deferred revenue in connection with equipment product should be in connection with equipment leases.

8. We ascertained that all software maintenance revenue and other software-related revenue, except for one new professional services customer and one new processing services customer, were from previously existing customers who renewed their maintenance contracts in the current audit year or requested some additional services. We concluded that the only deferred revenue in connection with software related services was primarily from recurring customers.

9. We determined that there were no other significant new revenue-producing customers acquired during the audit year.

10. We reviewed the information obtained in connection with our quarterly review procedures during the audit year and determined that it was not inconsistent with the foregoing.

Based on our updated knowledge of the type and sources of the revenue, we also determined the risk related to the existence of revenue was related primarily to (a) existence of accounts receivable at year end (for which our primary audit test was confirmation of receivables, as supplemented by alternate procedures for nonresponses), and (b) possible failure to defer the proper amount of unearned revenue billed for product and software related contracts. Thus, we responded to these risks in our audit scope by focusing and applying our substantive tests of details and analytical procedures on these areas.

Based on our review of materials published by the Board such as its 2013 summary of recent inspection findings,[6] or presented publicly in its forums and speeches, we believe the Board overemphasizes the near universality of significance of revenue as an area of audit focus when, in fact, risk levels in the revenue area, and the relative significance thereof, vary quite substantially from one business to another. In fact, in Part I of the Draft Report, the following statement appears about the effect of risk judgments on audit scope: "sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement…"

Identifying and addressing significant revenue-related assertions

As stated in the Draft Report, "AS No. 13 requires the auditor to design and implement audit responses that address the identified risks of material misstatement, and PCAOB Auditing Standard 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*** [***emphasis added***] 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." We firmly believe that the scope of our auditing of all revenue-related assertions, in all revenue categories, was sufficient in relation to the relatively low level of inherent risk of material misstatement rightfully perceived in the circumstances.

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[6] PCAOB Release No. 2013-001, February 25, 2013, p. 8.

With specific regard to the inspection staff's comments in the Draft Report about valuation of revenue, we note that the assertion categories described in the operative standard[7] imply that *existence* (or *occurrence*) and *completeness* each refer solely to a qualitative attribute while *valuation* (or *allocation*) is used in reference to a quantitative attribute. However, the standard permits the use of "financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated."[8], which is the approach we took as discussed in the **Audit procedures employed** below.

Since the standard allows for some flexibility, for practical reasons, it is our custom typically for revenue and expense accounts, to view the quantitative assertion, *valuation*, depending on whether we are looking at overstatement or understatement, on a combined basis with the qualitative *existence* or *completeness* assertion, respectively, as the assertions are described in the standard, rather than to look at *valuation* separately, and to reserve separate references to the valuation assertion primarily to balance sheet accounts as it was characterized in the predecessor standard.[9] As exceptions, however, we sometimes give separate consideration to *valuation* (or more precisely, *allocation*), whether for overstatement or understatement, when revenue is recognized based on estimates such as in multiple-element arrangements (of which there were none during the audit year inspected), percentage-of-completion accounting (which the issuer does not have) and other arrangements wherein billings are made (and receivables recorded) prior to completion of the earnings process, thus requiring deferral of revenue recognition.

Audit procedures employed

Based on our risk assessments, our understanding of and prior experience with the issuer, and our walkthroughs for selected revenue transactions to obtain an understanding of key controls and verify that they were actually in place, we selected an all substantive approach as the most efficient audit strategy to enable us to reduce the risk of undetected material misstatement to an appropriately low level and applied tests related to revenue assertions (primarily existence except as otherwise noted). We chose to employ procedures described in the standard as selecting specific items which "refers to testing all of the items in a population that have a specified characteristic, such as:

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7 AS 15.11.

8 AS 15.12.

9 AU 326.15.

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, *e.g.*, items that are suspicious, unusual, or particularly risk-prone or items that have a history of error,

- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account."[10]

Except with regard to open invoices included in receivables, our basic approach relative to revenue was a variation of what is described in the operative standard, which sets forth four alternative means of obtaining audit evidence that may be deemed appropriate for the circumstances, *i.e.* analytical procedures, and for tests of details, selecting all items, selecting specific items, and audit sampling, which we applied to open invoices included in receivables.[11] Whether employing audit sampling or not, the standard states that "[d]esigning substantive tests of details ... includes determining the means of selecting items for testing from among the items included in an account ... to obtain evidence that, ***in combination with other relevant evidence***, is sufficient to meet the objective of the audit procedure."[12] [***Emphasis added.***] Moreover, the sampling standard clearly acknowledges that "[n]onsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision and proper conduct of a firm's audit practice."[13]

Substantive tests of details:

1. [Existence] We tested consolidated revenue by selecting and inspecting a combined total of 117 product and software revenue transactions by examining invoices/contracts/shipping documents in connection with one or more of several procedures (of which 27 invoices were confirmed or subjected to alternative procedures in connection with our testing of open invoices within accounts receivable described in no. 5, below). We inspected these supporting source documents to ensure that the revenue was valid and recorded in the proper period (existence) and in the proper amount (valuation). These procedures were not intended to be standalone primary audit tests upon which a conclusion about the untested portion of the population was based. Rather,

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[10] AS 15.25 and .27. Note that the use of the terms, "such as" and "may decide," denote the bulleted items as examples and choices and, therefore, we believe they should not be interpreted as all-inclusive.

[11] AS 15.21-23.

[12] AS 15.22.

[13] IAS AU 350.11. (See also **fn 1** to the Appendix to the standard, AU 350.48, paragraph 4, added by PCAOB Release No. 2010-004, effective for audit years beginning on or after December 15. 2010.)

they served merely to afford additional corroborative evidence that further supported a conclusion that was based on a combination of tests, including procedures relating to deferred revenue and accounts receivable. The substantive tests of details described in this paragraph covered approximately $5,427,000 or 33% of consolidated total revenue. Including the items confirmed directly by the customer and those for which we vouched post-balance sheet cash collections, the total invoices/contracts/shipping documents/confirmations/cash remittance advices inspected increased the examined items to 147 and "coverage" to a total of approximately $5,843,000, or 35% of consolidated total revenue. Thus, we believe this constituted "a large proportion of the total amount of the items included in an account."[14]

Part II.A of the Draft Report states that we selected four months and one customer for each month to test for an element of the software-related revenue. In fact, our selection was considerably more thoughtful and methodical than that description would suggest and again, was not intended to represent a projectable sample for that category of revenue but rather was merely to provide additional corroborative evidence to further support a conclusion that was based on a combination of tests. Based on our judgmental risk analysis, we identified the only three months in which the total billings to individual customers were individually significant, and, therefore, posed the only significant risk of material overstatement. We also selected the next largest individual customer billing to test. Although the total selection was concentrated in these four months, the customers selected in this process were the only ones from whom the issuer had annual software-related revenue that totaled in excess of tolerable misstatement.

2. [Existence, Completeness, Valuation] For deferred lease revenue, we recalculated the total equipment deferred lease revenue for the year for each customer by computing the product of the number of equipment units on lease and the contractual lease price and also performed the substantive analytical procedure described in paragraph 1b in the list below.

3. [Existence, Completeness] For product royalty revenue, which was all derived from one customer, we obtained usage reports from such customer and recalculated the total royalties earned. In addition, we determined that the total amount of usage reported by the sole customer whose reports provided the basis for recording revenue approximated in the current year that of the prior year and was consistent with our expectations. (This type of revenue from this customer was approximately 1% of consolidated total revenue for both the current and prior year.)

4. [Completeness, Valuation] We tested selected revenue transactions that involved allocation to more than one period (*i.e.*, deferrals) by tracing to customer contracts and independently recalculating deferred revenue balances for approximately 66% of the total consolidated

[14] AS 15.25.

deferred revenue balance at year-end. This test also related to completeness and valuation. (Similar testing was done at the prior year-end.)

5. [Existence] We tested the accounts receivable balances by confirmation and alternate procedures for nonresponses at December 31, 2012, using statistical (monetary unit) sampling, which is tantamount to testing the entire population of revenue transactions within accounts receivable. The actual invoices selected by our statistical sampling software, plus the one additional key invoice we selected, totaled 57 open invoices within the year-end accounts receivable to examine. There were no material misstatements identified as a result of these procedures. The inspection team noted that we selected and confirmed 48 open invoices in accounts receivable. While this is correct with regard to the issuer's principal operating subsidiary, we also selected an additional eight selections from the other subsidiary, also using statistical (monetary unit) sampling, plus one key item. Collectively, the combined accounts receivable open invoice sample size (relevant because all the accounts receivable are controlled centrally) totaled 57 open invoices.[15]

6. [Existence, Completeness, Valuation] We tested details of cash receipts collected subsequent to the balance sheet date against the consolidated accounts receivable balances at December 31, 2012, by tracing approximately 64% to wires and/or checks. This test was not limited to confirmation nonresponses but was viewed as providing further corroborative evidence of existence of the receivables and related revenues as well as valuation (*i.e.*, collectability) of the receivables. When used as an alternative procedure for unreturned confirmations, we also examined shipping documents and/or remittance advices from the customers for evidence of revenue recognition in the proper period (existence and completeness). (Similar tests were performed at the beginning of the year in the prior audit, and no misstatements were identified.)

7. [Valuation] We tested details of significant accounts receivable write-offs and credit memos issued to customers for evidence of improper revenue recognition. Post-balance sheet write-offs and credit memos were found to be not material. There were no material misstatements identified as a result of these procedures.

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[15] Although we separately selected open invoices within accounts receivable for confirmation or the application of alternate procedures at each of Issuer A's two subsidiaries using the same tolerable misstatement and other sampling parameters, had we chosen what we understand to be the equally acceptable option (statistically) of combining the accounts receivable populations of the two subsidiaries for statistical sampling (using software that is widely used and tested) using the same parameters, the aggregate sample size would have been substantially the same (*i.e.* 59 as compared to the 57 invoices we tested).

8. [Existence, Completeness] We tested sales cut-off for product sales by selecting and inspecting ten invoices/shipping documents, five before and five after year-end. The five invoices before year-end are included in the 117 and 147 items noted in item 1, above. (Similar tests were performed at the beginning of the current audit year in the prior audit.)

9. [Existence, Completeness, Valuation] We performed tests of details on inventory pricing (*i.e.*, valuation) in the current and prior audit years, which provided us with an additional basis for placing substantial reliance, primarily regarding the revenue existence and completeness assertions, on the substantive analytical procedures applied to gross profit margins on product sales (see nos. 1a and 2, in the following list).

Substantive analytical procedures:

The inspection staff's commentary about our analytical procedures might have been appropriate based on what they could observe in our audit documentation had they been the sole or even a primary substantive test of revenue assertions possessing significant perceived levels of inherent risk. However, as we have stated above and explained in detail below, despite some unfortunate omissions and mischaracterization in our audit documentation, (a) our analytical conclusions were, in fact, based on reasonably reliable and supportable expectations, (b) we did not believe any revenue-revenue related assertion, in any revenue category, possessed a significant level of inherent risk, and (c) our analytical procedures were, in fact, not intended to provide sufficient evidential matter by itself about any assertion relative to an account balance or class of transactions but rather one of many forms of corroborative evidence obtained to support such assertions. *I.e.*, our conclusions relative to revenue were based on a collection of evidence obtained from aggregating the results of a combination of procedures that corroborated each other.

1. [Existence, Completeness, Valuation] We performed substantive analytical procedures to address adequately, in view of the relatively low level of perceived risk under the circumstances, the existence and completeness (and implicitly, valuation, as explained above) assertions on product sales and lease, license, maintenance, and processing revenues, primarily by customer by month, to support the existence and completeness assertions, noting the following:

    a. The gross profit margins realized on product sales should be expected to vary only within a narrow range and be consistent each month and from year-to-year because of the homogenous nature of the product (see no. 2, below).

    b. We analyzed deferred lease revenue as a percentage of the lease revenue noting that they were within our expectations and were consistent from year to year. Our expectations were developed based on there being no new lease customers, the number of machines being leased, and inspection of the lease agreements.

c. The software-related maintenance, license, and processing revenue by customer by month was also expected to vary only within a narrow range because there were no new licenses sold during the audit year, for which revenue was recognized, and the only revenue expected was the carryover from customers contracted in the prior year and the current year renewals, which amounts were contractually determined (and tested substantively) either when a license was initially sold or a new contract for processing services was entered into. These procedures confirmed our revenue expectations for each related type of revenue and customer, since substantially all revenue was from previously contracted customers except for one processing service customer, and did not result in any unexpected or unusual relationships in these revenue accounts. Although this conclusion was inadvertently not expressly documented, we believe it is apparent in our audit documentation. We developed our expectations based on what we evaluated to be plausible and relatively predictable relationships among the monthly data we obtained. Our expectations were based on the following considerations – (a) there were no new licenses sold during the year, (except for one new license customer for which there was no revenue recognized in the current year and one new processing customer); therefore, we expected to see revenue only from pre-existing customers, and (b) we expected recurring revenue from pre-existing customers that was primarily from contractually determined, recurring monthly charges.

2. [Existence, Completeness, Valuation] We compared monthly product revenues and costs and thereby confirmed our expectations that the gross margins were consistent during the year and year-over-year. This test of gross profit margins corroborated our work on overstatement assertions and constituted our primary test of completeness relative to the risk of undetected inventory shortages and royalty revenue. We developed our expectations based on what we evaluated to be plausible and relatively predictable relationships among the monthly data we obtained and the following observations: (a) there was only one new product introduced during the year, which was a variation of a pre-existing product, (b) the products sold by the issuer are homogenous in nature, (c) gross profit margins remained consistent within a narrow range during the year and year-over-year, (d) number of days' sales in accounts receivable and inventory turnover ratios remained relatively consistent with the prior year. Accounts receivable turnover was 5.5 times in 2012 compared to 6.0 times in 2011, and the inventory turnover was 7.3 times in 2012 compared to 7.33 times in 2011, (e) inventory levels remained relatively consistent, including the ratio of finished goods and raw materials to total inventory, compared to the prior year, and (f) there were insignificant inventory write-downs deemed necessary in the current and prior years for market markdowns or other reasons such as obsolescence or for shrinkage or other perpetual to physical adjustments.

3. [Existence, Completeness, Valuation] We tested consolidated deferred revenue analytically by comparing balances for each revenue-producing customer at December 31, 2012 to 2011, by

customer, which did not result in any unexpected or unusual variances based on the applicable contractual provisions. We noted that approximately 84% of the consolidated deferred revenue was for maintenance, processing and lease contracts from recurring customers from whom revenue is recognized ratably on a monthly basis, *i.e.* revenue was from continuing and predictable sources. These amounts were found to be consistent from year to year and in line with our expectations. Our expectations were based on the following considerations: (a) the absence of new, current year revenue-producing licenses, leases or other customer relationships that would entail revenue deferrals. Thus, we believe the risk of undetected material over- or understatement (*i.e.*, existence, completeness and valuation) of consolidated deferred revenue amounts was reduced to an appropriately low level.

Basis for substantive analytical procedures:

Product Subsidiary

We understand that the essence of risk-based auditing is embodied in AS 8.10, which states, in effect, that the appropriate level of detection risk for a financial statement assertion (i.e., the ability of the selected audit procedures to detect material misstatements in that assertion) is directly related to the perceived level of risk of material misstatement, which is clearly a matter of auditor judgment. As we have set forth under the caption "Our risk assessments relative to revenue and their effects on audit scope" our assessments of the risks of material misstatement in the revenue-related assertions was that they were low to moderate due to the absence of circumstances and conditions that are ordinarily associated with such risks. Such level of risk of material misstatement logically supports an audit approach that places more reliance on analytical procedures and less reliance on tests of details than might otherwise be the case such as with a higher risk assessment.

Further, as suggested in AU 329.09, we relied on substantive analytical procedures to achieve our audit objectives relative to revenue-related assertions only in combination with the tests of details described above.

For the gross profit margin analytical procedures, we followed the guidance contained in AU 329, as follows:

1. **Nature of Assertion** – The Product Subsidiary's products and revenues are predominately homogeneous, therefore our analytical procedures to support our conclusion, in addition to other substantive testing of account receivable and inventory, were appropriate and sufficient to support our opinion with respect to the existence, completeness and valuation assertions. Examining the revenues for this segment on a detailed basis would not necessarily detect overall material misstatements.

2. **Plausibility and Predictability of the Relationship** – The Product Subsidiary's revenue is tied specifically to a single deliverable product or is contractual and predictable in that it occurs in conjunction with a signed lease agreement for the product.

3. **Availability and Reliability of the Data** – The information used in our analytical procedures and in support of our expectations was developed under a reliable system with adequate controls evidenced by substantive testing of transactions in the current and prior year for receivables and inventory, as well as revenue transactions selected for detailed testing. We also noted that the inventory function was adequately segregated and independent of the financial reporting function. For lease revenues, the fixed asset list and lease contracts support the underlying information used in developing the expectation for deferred lease revenue and hence annual lease revenue. These asset additions are subjected to audit procedures on an annual basis.

4. **Precision of the Expectation** – The precision of the expectations with regard to gross margins is supported by documentation of our analysis of inventory turnover, testing of the inventory write-downs and allowances, ratios of inventory categories, accounts receivable turnover, testing of the allowance for doubtful accounts, testing of credit memos and the consistency of margins year over year, all of which support a consistent gross profit margin expectation. The precision of the expectation with regard to lease revenue is supported by the number of machines on the lease and the actual contractual lease rate.

In addition to the foregoing, we understand that the effectiveness of substantive analytical procedures depends primarily on the extent to which both the expectation and the explanations of any unexpected variances therefrom are supported by evidence and the extent to which the procedures are applied to disaggregated data. Although the conclusion and expectations in connection with these analytical procedures were not expressly documented, we believe it is readily apparent in our audit documentation.

Maintenance and Processing

We tested the remaining populations for maintenance and processing revenues using substantive analytical procedures, and we followed the guidance contained in AU 329, as follows:

1. **Nature of Assertion** – The Software Subsidiary's maintenance and processing revenues are contractually determined based on either a stated rate or level of activity and is predictable on a monthly and yearly basis and recognized on a monthly basis, therefore our reliance on analytical procedures to support our conclusion was appropriate and the procedures were

sufficient to support our opinion with respect to the existence, completeness and valuation assertions.

2. **Plausibility and Predictability of the Relationship** – As noted above, the Software Subsidiary's maintenance and processing revenue is contractual and predictable in that it occurs in conjunction with a signed agreement with stated terms.

3. **Availability and Reliability of the Data** – The information used in our analytical procedures and in support of our expectations was developed under a reliable system with adequate controls evidenced by substantive testing of transactions in the current and prior year for receivables, deferred revenue, as well as revenue transactions selected for detailed testing which include testing of pre-existing customers with recurring revenue streams from renewals.

4. **Precision of the Expectation** – The precision of the expectations with regard to maintenance revenue is supported by existing customers, of which there were only 11 customers, and generally fixed rates of renewal. The precision of the expectations with regard to processing revenue is supported by the two existing customers and processing rates that do not deviate significantly year over year. For the one new customer, we treated it as a deviation from expectations and, accordingly, we applied a test of details.

As noted above, in addition to the foregoing, we understand that the effectiveness of substantive analytical procedures depends primarily on the extent to which both the expectation and the explanations of any unexpected variances therefrom are supported by evidence and the extent to which the procedures are applied to disaggregated data. We have addressed all of these above and in our letter of response.

Wherever variances from our expectations were encountered in our substantive analytical procedures, we inspected the related customer contracts or other underlying records to verify management's explanations for the variances or otherwise substantiate and determine the reason for the variance noting no material misstatements. In addition, we believe our various applications of substantive analytical procedures effectively constitute applications to disaggregated data that reduce risk, as provided by the standard.[16]

The accompanying Appendix includes a tabular summary intended to supplement the foregoing text to visually demonstrate how we achieved sufficient evidence to support the principal revenue assertion of existence (which in this case, as stated above, includes valuation) as well as completeness.

[16] IAS AU 329.19.

Professional judgment

We are aware that the PCAOB published a Release entitled *Information for Audit Committees About the PCAOB Inspection Process*, which contained the following comments about professional judgment:

> "Firms' responses [to reported inspection findings] also sometimes characterize deficiencies in terms of professional judgment. Specifically, firms sometimes assert or imply that audit deficiencies cited by PCAOB inspectors reflect differences of professional judgment between the inspection staff and the audit firm within a range of acceptable professional judgments.
>
> "In the Board's view, these assertions ... should be viewed with skepticism."[17]

We concur with the Board's stated view about applying a measure of skepticism in the face of obviously unsupported, overly defensive and self-serving assertions about professional judgment but nevertheless, we maintain that knowledgeable professionals can, and frequently do, disagree, most particularly as to good faith, well thought-out and risk-focused judgments about audit scope determination and other matters not clearly dictated by authoritative standards, *i.e.*, where there is not likely to be a matter-of-fact, objectively determinable right or wrong. Historically, we have seen numerous examples of legitimate disagreements among experienced, knowledgeable professionals, including accredited experts testifying in courts of law, over auditor judgments on matters of audit strategy, risk assessment and other audit scope decisions.

We point out that in 2005, the PCAOB issued a release containing a policy statement that was limited specifically with respect to internal control audits performed under its then effective AS 2. In that Release, among other things, the Board expressly stated that (a) it does not intend for its inspectors to discourage "the use of judgment and tailored audit planning" and (b) "by focusing on appropriate use of judgment and risk assessment, we are deliberately planning our inspections in a manner that promotes an audit ... that is both thoughtful and risk-focused. In other words, ***we do not intend to second-guess good faith audit judgments***."[18] [**Emphasis** ***added***.] We firmly believe, however, that there is no justifiable reason that the Board policy contained in that Release should not be applied equally to the inspection of financial statement audits especially when considering the compelling need to apply judgment when interpreting the many vague terms prevalent throughout our auditing standards, such as "reasonable assurance" or a "low level" of risk.

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17 PCAOB Release No. 2012-003, August 1, 2012, p. 6.

18 PCAOB Release No. 2005-009, May 16, 2005, p. 14.

Our conclusion

We have given the inspection comments contained in the Board's draft inspection report careful and thoughtful consideration and re-evaluated our work pursuant to the guidance contained in the applicable standards.[19]

In all respects particularly regarding our audit scope determinations, we believe that there is considerable support and room for judgment when it comes to the matters discussed in the Draft Report, and we continue to be satisfied that those audit scope decisions were sound, good faith judgments made by competent professionals based on thoughtful risk assessment and an analysis of the issuer's business and industry and the environment in which it operates, and we remain fully confident in those judgments. Based on our re-evaluation, we firmly believe that neither the facts and circumstances nor the applicable professional standards support the inspection staff's conclusions.

Nonetheless, as a direct response to PCAOB criticism, we opted to perform additional tests of details on the revenue populations covered by our originally designed substantive analytical procedures. The procedures were as follows:

For the product subsidiary, using statistical (monetary unit) sampling, which is tantamount to testing the entire revenue population, we sampled the product revenue population which was originally covered by our substantive analytical procedures, yielding 288 additional revenue invoice selections for testing. For these additional selections, we obtained the invoice, signed shipping documents, purchase orders and/or lease agreements for product shipped or leased, and cash collections, to further validate the existence and valuation assertions. We also sampled 2013 shipments for the month of January, using a statistical (monetary unit) sample, to further validate the completeness assertion of revenue. This testing included the examination of shipping documents and invoices for 24 items for proper inclusion or exclusion from revenue. Our testing yielded no exceptions.

For revenues related to the software subsidiary (including maintenance, processing and professional services revenues), we tested 95% - 100% of the revenues in these categories previously untested or covered originally by our substantive analytical procedures using both statistical (monetary unit) sampling or selecting items above a specified threshold. For these additional selections we obtained the contracts and respective invoices, as well as cash collections to validate the proper revenue recognition in support of the existence, completeness and valuation assertions. Our testing yielded negligible differences.

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[19] IAS AU 390

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The results of this testing had no impact on our issued audit opinion.

In summary, we believe the aggregate results of the procedures originally performed clearly provided sufficient audit evidence as to the existence (including valuation, as explained above) and completeness of revenue to reduce the risk of undetected material misstatement in the unexamined populations to an appropriately low level as required by the standards.

Very truly yours,

Habif, Arogeti & Wynne, LLP

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APPENDIX

PUBLIC RESPONSE TO DRAFT REPORT OF INSPECTION

	Total Revenue		Product Revenue		Other Revenue		Assertions
	$ (000's)	%	$ (000's)	%	$ (000's)	%	Tested
Substantive tests of details:							
Nonsampling selection of revenue transactions (invoices and shipping documents/statements of work/software contracts/maintenance contracts/processing contacts and invoices/lease contracts)	$ 2,854	17%	$ 717	6%	$ 2,137	57%	E, V
Statistical sampling of accounts receivable invoices (tantamount to testing the entire population of revenue trasactions within accounts receivable)	3,065	19%	2,475	19%	590	16%	E
2012 cutoff testing of invoices	62	0%	62	0%			E, C
2011 cutoff testing of invoices that relate to 2012	2	0%	2	0%			E, C
2012 deferred revenue testing	407	2%	33	0%	374	10%	E, C, V
2011 deferred revenue tested that was recognized in 2012	712	4%	353	3%	359	10%	E, C, V
Substantive analytical procedures:							
Lease revenue and deferred lease revenue	1,861	11%	1,861	15%			E, C, V
Recalculating deferred lease revenue	248	2%	248	2%			E, C, V
Gross profit analysis	10,749	65%	10,749	84%			E, C, V
Monthly recurring maintenance revenue	1,456	9%			1,456	39%	E, C, V
Monthly recurring license revenue	214	1%			214	6%	E, C, V
Monthly recurring processing revenue	220	1%			220	6%	E, C, V
Recalculation of royalty revenue	199	1%	199	2%			E, C, V
SUBTOTAL	22,049	133%	16,699	130%	5,350	144%	
Less amounts duplicated in multiple tests above	(6,554)	-40%	(3,890)	-30%	(2,664)	-72%	
TOTAL REVENUE TESTED	15,495	94%	12,809	100%	2,686	72%	
Untested revenue	1,035	6%	-	0%	1,035	28%	
TOTAL CONSOLIDATED REVENUE REPORTED	$ 16,530	100%	$ 12,809	100%	$ 3,721	100%	

Assertions Legend:
E - Existence
C - Completeness
V - Valuation