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Inspection of Fontanella and Babitts CPAs

Issued by the

Public Company Accounting Oversight Board

May 21, 2008

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. 104-2008-080A
(Includes portions of Parts II and IV of the full report that
were not included in PCAOB Release No. 104-2008-080)



Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.



INSPECTION OF FONTANELLA AND BABITTS CPAs

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Fontanella and Babbitts CPAs^{1/} ("the Firm"). The Board is issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report 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.^{2/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{3/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Firm has issued audit reports under the name of Fontanella and Babbitts.

^{2/} 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 addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

^{3/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted fieldwork for the inspection from October 1, 2007 to October 5, 2007. The fieldwork included procedures 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	1 (Totowa, New Jersey)
Ownership structure	Partnership
Number of partners	3
Number of professional staff ^{4/}	8
Number of issuer audit clients ^{5/}	1

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.^{6/} To achieve that goal, Board

^{4/} "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.

^{5/} 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. In some circumstances, a Board inspection may include a review of a firm's audit of financial statements of an issuer that ceased to be an audit client before the inspection, and any such former clients are not included in the number shown here.

^{6/} This focus necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

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.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.^{7/} 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, are free of any deficiencies not specifically described in an inspection report.

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 scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope. This review did not identify any audit performance issues that, in the inspection team's view, resulted in the Firm failing to obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements.

B. 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. As described above, any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain

^{7/} When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.



nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I



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PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED
FROM THIS PUBLIC DOCUMENT

PART II

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The inspection of the Firm included consideration of aspects of the Firm's system of quality control. Assessment of a firm's quality control system rests both on review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements.^{8/} On the basis of the information that the inspection team reported, the Board has the following concerns about aspects of the Firm's quality control system.

1. Design of Quality Control System

Independence Procedures

The Firm's independence procedures appear not to meet the requirements of PCAOB Rule 3400T(b),^{9/} in that the Firm does not have procedures to obtain independence certifications from its personnel and verify the completeness and accuracy of independence representations made by the Firm's partners.

^{8/} A firm's failure to comply with the requirements of PCAOB standards when performing an audit may be an indication of a potentially significant defect in a firm's quality control system even if that failure did not result in an insufficiently supported audit opinion.

^{9/} PCAOB Rule 3400T(b) requires registered firms to comply with the quality control standards described in section 1000.08(o) of the American Institute of Certified Public Accountants SEC Practice Section Reference Manual, which in turn requires that a firm have policies and procedures in place to comply with Appendix L, section 1000.46 of that manual.

2. Audit Performance
 - a. Fraud Procedures

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will perform all required procedures in accordance with the provisions of AU 316, *Consideration of Fraud in a Financial Statement Audit*. Specifically, the Firm did not perform audit procedures to test journal entries and other adjustments for evidence of possible material misstatements due to fraud and failed to hold a discussion among engagement personnel regarding the risks of material misstatement due to fraud.^{10/} [Issuer A]

* * * *

^{10/} 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; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

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.^{11/}

^{11/} 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.

Fontanella and Babitts

CERTIFIED PUBLIC ACCOUNTANTS

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April 1, 2008

Mr. George Diacont, Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006

Re: Response to the Public Company Accounting Oversight Board
Draft Report on 2007 Inspection of Fontanella and Babitts CPA's

Dear Mr. Diacont:

We are pleased to provide this response to the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") draft report (the Report) on the inspection of Fontanella and Babitts, CPA's (the "Firm"), performed during 2007.

Regarding the Board's comment on the Firm's independence procedures:

Our firm's policy regarding independence is clear, well established within our firm, and verbally communicated to all partners and staff members. In fact, our firm's requirements go well beyond the requirements of the PCAOB and other industry guidelines.

We have instituted procedures to obtain signed independence certifications from our partners and all staff members and procedures to verify the completeness and accuracy of those certifications.

Regarding the Board's comment on the Firm's fraud procedures, including journal entry testing:

The audit team reviewed 100% of all journal entries recorded by the client during the six months ending on the balance sheet date and for the additional period through the date of the audit report. That review did not uncover any unusual journal entries, in our opinion, that required additional attention.

In addition, we audited 100% of all balance sheet general ledger control account reconciliations and all significant income statement accounts. The audit of the income statement accounts involved substantive testing including, but not limited to, analytical procedures, review of account histories for unusual activity, vouching, and recalculation on a test basis.

The audit engagement team held discussions all throughout the audit including during the planning phase. Documentation supporting the planning phase meeting was erroneously omitted from the workpapers.

In response to this comment the firm has instituted procedures to better document the testing of specific journal entries in conjunction with the audit of general ledger control account reconciliations, to better document the analytical procedures performed during the planning phase of the audit and document the meeting held among the engagement team during the planning phase.

Mr. George Diacont, Director
Division of Registration and Inspections
Public Company Accounting Oversight Board

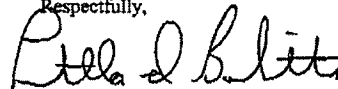
2.

REDACTED

Comments on Non-public Aspects of Report

We appreciate the opportunity to provide this response and look forward to further dialogue with the Board's Inspections Staff or the Board about enhancing audit quality and improvements to the auditing profession.

Respectfully,


Fontanella and Babitts