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

Inspection of Piercy Bowler Taylor & Kern Certified Public Accountants

Issued by the

Public Company Accounting Oversight Board

January 25, 2007

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

RELEASE NO. 104-2007-017

Release No. 104-2007-017

PCAOB

Public Company Accounting Oversight Board

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 Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP 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, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

PCAOB
Public Company Accounting Oversight Board

INSPECTION OF PIERCY BOWLER TAYLOR & KERN
CERTIFIED PUBLIC ACCOUNTANTS

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Piercy Bowler Taylor & Kern Certified Public Accountants ("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.[1/]

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.[2/] 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 Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

[2/] 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 May 2, 2005 to May 6, 2005. 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 (Las Vegas, Nevada)
Ownership structure	Professional corporation
Number of partners	5
Number of professional staff[3/]	43
Number of issuer audit clients[4/]	10

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. 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.

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

[3/] "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.

[4/] 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.

conformity with 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, are free of any deficiencies not specifically described in an inspection report.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of the performance of six of the Firm's audits of the financial statements of issuers. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

The inspection team identified matters that it considered to be audit deficiencies.[6/] The deficiencies identified in two of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. Those deficiencies included –

(1) the failure to perform and document adequate audit procedures related to the revenues of two issuers; and

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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 GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

6/ PCAOB standards require a firm to take appropriate actions to assess the importance of audit deficiencies identified after the date of the audit report to the firm's present ability to support its previously expressed opinions. See AU 390, *Consideration of Omitted Procedures After the Report Date,* and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T). Failure to comply with these PCAOB standards could be a basis for Board disciplinary sanctions.

(2) the failure to perform and document adequate audit procedures related to patents and acquired technology.

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies and procedures concerning audit performance, 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 nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

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

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 Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act 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. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final 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. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.

P B T K

PIERCY BOWLER TAYLOR & KERN

Certified Public Accountants • Business Advisors

May 26, 2006

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

Re: Response to PART I of Draft Inspection Report on
PIERCY BOWLER TAYLOR & KERN Certified Public Accountants

Dear Mr. Diacont:

We appreciate the opportunity to present our views with respect to the findings expressed in the draft report of the PCAOB (also referred to herein as "the Board") dated May 4, 2006, as a result of the inspection conducted of our firm's SEC audit practice in May 2005.

Because the first portion of our response is to be accessible by the public, a list of frequently used abbreviations is provided and attached as an appendix to assist public readers. Although this portion of our letter is intended to respond to PART I of the draft report, it necessarily makes reference to certain details contained in PART II.A of the draft report, which we understand will not be made public when finalized. The second portion of our response contains additional comments for which confidential treatment is requested pursuant to section 104(f) of the Sarbanes-Oxley Act of 2002 ("the Act) and PCAOB Rule 4007(b).

We are a firm of dedicated and skilled professionals committed to delivering the highest quality of professional services performed in accordance with all applicable standards and regulatory requirements. We assure you that we take quite seriously the practice monitoring efforts and formidable responsibilities of the Board and the peer review programs (in which we have always participated), as well as our own rigorous quality control system. We have always sought and welcomed feedback from those engaged in practice monitoring activities and others as to how to improve our audit quality and will continue to do so.

The foregoing notwithstanding, we believe that knowledgeable professionals can disagree, particularly as to matters of audit scope determination and other matters of judgment that are not clearly dictated by authoritative standards, where there is not likely to be a matter-of-fact right and wrong. In fact, Rule 102 (ET 102.01) of the AICPA's *Code of Professional Conduct* requires us to maintain our objectivity with regard to professional services and not subordinate our judgment to that of others.

In that regard, we have carefully evaluated the judgments made by our auditors in the engagement matters discussed herein as well as those views expressed by the Board's inspectors and reflected in its draft report. Accordingly, based on our considerations, we continue to be confident that our auditors' judgments in these matters were sound, good faith judgments made by competent professionals based on many hours, and frequently years, of thoughtful analysis of each client's business and industry and the environment in which they operate, and consistent with what we believe is our professional obligation under the circumstances, we remain in full support of those judgments although we continue to fully respect the fact that the judgments of others may differ.

Accordingly, we are presenting in considerable detail our supporting rationale and separate conclusion for each matter contained in the draft report to insure that the Board understands the facts and considerations that support our professional judgments and to gain the Board's concurrence that, despite certain minor deficiencies observed by the inspector, which we acknowledge, our firm did, in fact, obtain sufficient competent evidential matter to support its opinion on each issuer's financial statements.

Our risk-based audit methodology that provides the guidance we use to determine audit scope for each client circumstance is quite similar to the methodology and philosophy set forth in a popular reference source on risk-based auditing co-authored by Dr. Douglas R. Carmichael, formerly the Board's Chief Auditor and Director of Professional Standards, David L. Landsittel, former ASB Chairman, and others (referred to frequently in the following pages, collectively, as Carmichael, *et al*).[1] Our firm and its principals have been applying these concepts in our practice and in providing training, consultations and written guidance to other professionals in this regard for 25 years.

In summary, we understand that the authoritative auditing literature is not intended to constitute an inflexible cookbook for conducting audits, and that the use of auditor judgment as to matters of scope determination is the essence of modern risk-based auditing. Professional standards contain virtually countless expressions of the importance of applying professional judgment, for example, AU 312.13 and .28, throughout SAS 22 (AU 311, particularly AU 311.06-.08), and in many other requirements contained elsewhere in our literature.

We are available to engage in cooperative dialog with Board representatives to mitigate the potential for misunderstandings and to narrow our differences of opinion before the Board's final report is issued.

Please address any questions about this letter of response to Howard B. Levy, Director, Technical Services, who may be reached at 702/384-1120, 702/279-5389 or by e-mail at hlevy@pbtk.com.

Thank you in advance for your consideration.

Very truly yours,

PIERCY BOWLER TAYLOR & KERN
Certified Public Accountants

Piercy Bowler Taylor + Kern

cc: Thomas Ray
Chief Auditor and Director of Professional Standards

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[1] *PPC's Guide to Risk-Based Audits*, Eighth Edition (Online Version), February 2005

Redacted

Confidential Treatment Request Granted by the Board
Pursuant to PCAOB Rule 4007(b)

MATTER 2 (Subparagraph (2) of PART I.A), ISSUER B

This matter (identified in Part II of the Board's draft report as section A2) that is characterized as one of two significant deficiencies relative to revenue auditing in subparagraph (2) of PART I.A of the draft report relates to a question as to the adequacy of the scope of auditing procedures applied to Issuer B's equity in net income of a 50% joint venture investee, which was the issuer's only revenue and material.

- **Absence of specific authoritative or useful nonauthoritative literature**

The last authoritative auditing literature to expressly and directly address the determination of an appropriate audit scope to be applied to the financial statements or accounts and transactions of an investee carried on the equity method of accounting, which was extremely limited, was Section 332 of the codification of SAP nos. 33-51, SAS 1, issued in late 1972. The original Section 332 was derived from SAP 51, issued earlier the same year, but was superseded in its entirety in 1996 by SAS 81, at which time such guidance specific to equity investees disappeared from the authoritative auditing literature, and again in 2000 by SAS 92. As a result, since 1996, auditors have had to rely solely on the broad, general guidance in other standards applicable to audit scope determination, nonauthoritative literature, and their own judgment as to the nature and extent of auditing procedures to apply to such investments and the income (or revenue) derived therefrom.

Even SAS 1, sec. 332 (the original version of AU 332, as codified from SAS 51), before it was eliminated from the literature, contained little or no useful, practical guidance for determining the appropriate scope for auditing income from equity method investees when unable to rely on audited financial statements. In its original form, it states only the following on that subject:

- "By application of auditing procedures to the financial statements of an investee, the auditor obtains evidential matter as to the equity in underlying net assets and results of operations of the investee. The auditor for the investor may utilize the investee's auditor for this purpose. The materiality of the investment in relation to the financial statements of the investor is a factor which should be considered in determining the extent and nature of such procedures" (SAS 1, sec. 332.05 b(ii)), and repeats

- "Auditing procedures (see paragraph .05 b(ii)) should be applied to such unaudited financial statements to the extent considered necessary in view of their materiality in relation to the financial statements of the investor." (SAS 1, sec. 332.11)

The nonauthoritative sources we located contain nothing more useful than statements that the auditor may use audited financial statements of the investee, or if unavailable, unaudited financial statements supplemented by the application of auditing procedures applied to selected items or portions thereof to the extent necessary in the auditor's judgment. These sources substantially track but do not supplement or update the limited guidance that appeared in SAP 51 over 36 years ago leaving auditors only their own judgment to rely upon.[2]

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[2] For example, see Commerce Clearing House's online reference service, Accounting Research Manager / *Miller Audit Procedures,* 2006 Edition, Chapter 9, which, in regard to determining the appropriate scope for auditing income from equity method investees when unable to rely on audited financial statements, merely states that, "the investor's auditor should apply, or should request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to the investee's financial statements. In making this decision, the investor's auditor should take into consideration the materiality of the investment in relation to the financial statements of the investor." PricewaterhouseCoopers' online reference service, Comperio® / *Montgomery's Auditing*, 12th Edition, Chapter 21, says even less about this: "...the auditor should apply auditing procedures to those statements in light of the materiality of the investment in relation to the investor's financial statements." In our view, to be consistent with modern auditing standards, the last part of this sentence should have read "the risk of a misstatement material to the investor's financial statements."

MATTER 2 (continued)

- **Principles of audit scope determination**

In defense of our audit scope decisions made regarding the equity in net income of an unconsolidated investee presented in the financial statements of our client, Issuer B, we call specific attention the brief summary of our understanding of certain basic principles of modern financial auditing, particularly as to the use of auditor judgments in scope determination that is presented in brief summary on page 17 of this response and mention that these principles were introduced into the auditing standards, primarily in SAS 47 (AU 312), almost a decade after SAP 51 was issued.

It appears but is not clear that the comments in Part II, section A2, of the draft report were intended to imply a view that some form of detailed transaction testing of revenues should have been performed at the either the level of the investee (which, as discussed further below, is a management company) or that of the entity it manages (which is not a component entity but rather, in substance, its customer) or both. However, it is our view that neither was necessary. Instead, we share the view expressed by "Carmichael, *et al*" that substantive tests of transactions are to be performed solely at the auditor's discretion not routinely but only in particularly high risk areas.[3]

- **Specific engagement facts**

In this audit engagement, we obtained the necessary understanding of the equity investee's business, the environment in which it operates and the inherent risks associated with its financial reporting process that we deemed necessary to determine the appropriate scope of auditing procedure to apply in our audit of the investor's financial statements. We regret that, despite what we believe to be extensive documentation thereof, in our audit workpapers, in full compliance with AS 3, considerable dialog with the inspector in the short time span of the inspection, and in our written response to the comment submitted thereafter, we were apparently unable to adequately communicate it to the inspector, and we still believe the inspector reached an incorrect conclusion.

As a management company, the equity investee manages, under a contract, a highly regulated business. Under the management contract, the investee was paid fees that are dependent on the gross revenue of its in-substance customer, the managed business. We determined based on our understanding of its operations, that the management company does not bear any of the operating expenses of the managed business but incurred only a relatively small amount of payroll (for one person) and other minor administrative expenses that, in the aggregate, were so insignificant in relation to our client's financial statements as to have almost no inherent risk of material misstatement. We supported this assessment with an overview of the search for unrecorded payables viewed as performed on behalf of management by another CPA firm in a role that we regarded for our purposes of determining our audit scope as that of an outsourced controller. (In reality the CPA firm performed audits of the financial statements of both the investee and the managed business in accordance with generally accepted auditing standards and represented its independence to us under both AICPA and SEC rules. However, it was not a PCAOB-registered firm.) Although we did not rely on its work in any sense as contemplated by AU 543 (and the Board's inspectors concurred), we reviewed it to re-affirmed our preliminary conclusion that there was little or no risk presented from underreported expenses. We believe our approach and conclusion was consistent with the risk-based principle set forth in AU 312.32 to conclude that no substantive auditing procedures are necessary when the auditor's judgment is such that a material misstatement could not exist (or even if the probability thereof is judged to be remote).

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[3] *Op cit*, para. 500.23

MATTER 2 (continued)

Since the investee carried virtually no accounts receivable from its sole in-substance customer, and distributed substantially all of its net earnings quickly to its equity holders, it had no need for or incentive to incur unrecorded debt, the proceeds of which might be used to overstate revenues and income and, therefore, we were not concerned with revenue existence. However, we concluded (a) that there was some inherent risk, primarily as to completeness of its recorded management fee income that could produce material understatement of its net income and (b) that, therefore, it was necessary to perform, and we did perform, substantive tests for completeness of the management fee revenue earned by the investee.

We concluded and still believe, based primarily on our risk considerations and our understanding of the applicable requirements of professional standards, that it was sufficient under the circumstances to limit our substantive testing to (a) tracing the revenues as reported by the managed business to the investee and to its revenue reports to the regulatory authorities, (b) independently recalculating the management fees recorded by the investee based on such reported revenues, and (c) verifying that such fees were determined in accordance with its management contact, which we also inspected, all of which work was adequately documented and the documentation made available to the Board's inspector. Consequently, we do not understand how it can be stated in Part II, section A2, of the draft report that we "did not perform any audit procedures relating to the operating results of either the managed business or the joint venture investee," which statement is factually inaccurate with regard to the joint venture investee and implies an obligation relative to the in-substance customer of the investee that we do not believe exists.

- **Applying auditing procedures at the managed busness level**

With regard to the in-substance customer, we nevertheless considered whether auditing procedures should have been applied at that level to test the completeness of its reporting of revenues to the management company investee resulting in incompleteness of revenue and income reported on the investee. (Once again, testing of existence would have been entirely irrelevant since payments were being timely remitted based on reported revenues.) We concluded that testing for completeness was unnecessary for several reasons, as follows:

(a) We were not auditing or opining on the financial statements of the investee and thus, were concerned only with its net income, not with any issues regarding classification within the investee's income statement (or balance sheet), in other words, "geography." Accordingly, we believed (and still believe) that we need not be concerned with underreported revenue at that level for if it were to be discovered, (pursuant to FASB *Current Text*, Sections R75.101 and .103) it would likely be either not recognizable as income by the investee or recorded as both revenue and expense as a result of doubtful collectibility of any related receivable that might then be recordable, thus not affecting the investee's net income or the investor's (Issuer B's) 50% equity therein.

(b) As the contract manager of the in-substance customer's business, the investee was in full control of its revenue reporting and, therefore, not likely to underreport its revenues since these revenues are the basis for determining the investee's management fees, unless it was in a position to engage in skimming. (But illegally obtained assets skimmed by the investee's management or other employees would not likely accrue to the issuer as part of its legitimate equity method income.)

(c) Based on our understanding of the regulatory environment, in which the regulators have a direct stake in the revenue reporting that is the basis for the applicable regulatory gross revenue tax and provide close supervision of the operations to assure the opportunity for skimming in minimized. (This is direct supervision by a regulatory stakeholder, not internal control or internal audit activity, and therefore is viewed as directly reducing rather than mitigating inherent risk.)

(d) We are not aware of even a slight suggestion anywhere in the literature, authoritative or not, of an auditor obligation to apply auditing procedures at the level of an equity investee's customer (or even an audit client's

MATTER 2 (continued)

customer) when revenues such as management fees or contingent rentals, for example, are determined based on data supplied to it by the customer, regardless of their significance. (In the case of an audit client whose revenue is dependent on data submitted by a customer, an auditor might likely be concerned with the client's internal control over the completeness of such customer- reported data, but for reasons set forth in (a), above, we believe that principle would not apply for an equity investee.)

The foregoing rationale regarding the lack of a need for testing at the investee's in-substance customer level was not documented in our workpapers because we understand the operative audit documentation standard (PCAOB AS 3) does not impose any burden on auditors to document reasons for not selecting and performing specific audit procedures except when expressly required by another standard, such as confirming accounts receivable or observing physical inventory-taking. Nevertheless, having re-examined as intensely as we have this and other audit scope issues related to the issuer's equity in net income of its investee raised by the Board's inspectors, we have requested that engagement team members place additional documentation of our rationale in the workpaper file.

- **Our conclusion**

Based on the foregoing facts and analysis, on our understanding of the fundamental principles of risk-based auditing and applicable professional standards, and our risk assessment process as applied in this audit, we do not understand the basis for the Board's draft conclusion (Part II, section A2, of the draft report) that states, without qualification, that we "should have performed and documented adequate testing of revenues to provide a basis to conclude as to the existence and completeness of the issuer's recorded revenues," and we continue to believe that it is unwarranted in the circumstances, that we examined sufficient evidence to support our opinion in this engagement and, therefore, that no further action is necessary to comply with the applicable auditing standards, including AU 390. Accordingly, we request that the Board reconsider and withdraw it conclusions regarding this matter and this engagement. Nevertheless, because of the questions raised by the Board's inspectors, we increased the scope of work performed with regard to the investee's operation in our 2005 audit recently completed.

MATTER 3 (Subparagraph (2) of PART I.A), ISSUER C

This matter (identified in Part II of the Board's draft report as section A3b) that is characterized as one of two significant deficiencies relative to revenue auditing in subparagraph (2) of PART I.A of the draft report relates to a question of the adequacy of the scope of audit work regarding a portion of the revenues reported by Issuer C.

- **Principles of audit scope determination**

In defense of our audit scope decisions made regarding revenue, we believe it is necessary to call attention to our understanding of certain relevant basic principles of modern, risk-based financial auditing, particularly presented in brief summary on page 17 of this response.

It is also pertinent in this matter to mention that materiality, as defined in FASB Concepts Statement 2 and discussed in AU 312.10, is determined in terms of how an omission or misstatement might influence the judgment of financial statement users. Since an audit opinion affords reasonable assurance as to the absence of misstatements (including omissions) that are material in relation to the financial statements, taken as a whole, based on auditors' professional judgments that are "made in the light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations," it is embodied in the definition of inherent risk such that auditors perform substantive tests only when a risk of material misstatement is perceived.

- **Specific engagement facts and considerations**

In determining the scope and approach to be used for this audit engagement, because of the limited, barely out of development stage, revenue activity, we concluded that revenue was not a key audit area that warranted significant audit attention.

Implicit in the Board's comment is what we believe to be an erroneous notion that the $256,000 is certain foreign sales is material (and, therefore, demanding of significant audit attention) because of it relationship to total reported revenues. We take exception with that on three levels:

(1) As stated above, materiality should be gauged in relation to the financial statements, taken as a whole, not in relation to revenues,

(2) As explained in an earlier section of this letter of response, audit effort should be based on inherent risk (risk of material misstatement), not merely materiality in the absolute. If one were to posit that materiality should be 10% of net loss (there was no tax benefit or provision), foreign sales would have to be overstated or understated by an extremely unlikely 63 %, and

(3) Based on the Company's near start-up status, user focus for evaluation purposes was not likely to be on its rather nominal historical revenue but rather its prospects for future sales, which are discussed only outside the financial statements.

Even if revenue had been seen as a significant audit area, accounts receivable balances were nominal in relation to the balance sheet and the financial statements as a whole such that we perceived little or no inherent risk as to revenue overstatement (existence or occurrence). Had revenue been a key audit area and receivables been material, we would have obtained satisfaction as to revenue occurrence primarily by auditing the asset for existence. Under our risk-based approach, relying principally on tests of receivables balances, possibly supported by corroborative analytical procedures and, in the face of identified specific risk conditions, possibly cutoff tests, we ordinarily find it unnecessary to apply detailed tests to sales

MATTER 3 (continued)

transactions. Instead, we share the view expressed by Carmichael, *et al* that substantive tests of transactions are to be performed solely at the auditor's discretion, not routinely, but only in particularly high risk areas.[4] Exceptions are made for special perceived risks, for example, possibly questionable revenue recognition practices, none of which were identified in this engagement.

In this case, our engagement team decided to perform detailed tests of revenue transactions merely because of their inability to use our normal approach due to the lack of receivable balances to test. In a field visit, the partner concluded that the detailed revenue testing was not warranted since no valid audit objective was being served due to the lack of perceived inherent risk relative to existence or occurrence. So he discontinued the test that was already completed for domestic sales without proceeding to test the subject foreign sales transactions. As observed by the Board's inspector, this decision, however, was not documented in the engagement workpapers, and we have supplemented the workpapers accordingly, following the guidance in PCAOB AS 3.

Since the issuer had control over the customers and sales serviced by its foreign manufacturing and distribution centers, its management believes that the risk of material underreported foreign sales (completeness) is minimal, and we concurred.

- **Exclusive use of substantive analytical tests**

Regarding the exclusive use of substantive analytical tests, Carmichael, *et al* state that it may be sufficient except in higher risk situations, as follows:

> "A risk-based audit focuses heavily on the use of analytical procedures because they can be the key to both improving audit effectiveness and efficiency. ... The auditor may determine that an analytical approach is sufficient to address the identified risks. However, based on his or her judgment, additional tests of details may be necessary in higher-risk areas or for particular financial statement assertions that the auditor has assessed as higher-risk."[5]

Although AU 329.09, as amended in September 2004 by PCAOB Release 2004-008, states that "it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient," consistent with the Carmichael, *et al* quote immediately above, it is not precluded for particular assertions when inherent risk is perceived as almost nonexistent. In this case, the analytical test performed after the inspection was viewed as gratuitous and unnecessary.

Based on the foregoing and as we believe the standards permit, at the time of the audit, we saw no need for any further testing of revenue details as to either existence or completeness (including for cutoff, which addresses both). Nevertheless, despite our view that AU 312.32 permits an auditor to conclude that no substantive auditing procedures are necessary when the auditor's judgment is such that the probability of a material misstatement could be no more than remote (which was and still is our judgment in this matter), we did request that the engagement team perform analytical revenue tests of gross profit, primarily to obtain additional comfort as to revenue completeness, which was done with satisfactory results and documented. In this case, we believe the need for such additional testing could be viewed, at worst, as a

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[4] *Ibid*, para. 500.23

[5] *Ibid*, para. 101.11. (See also similar language in para. 400.6.)

MATTER 3 (continued)

minor deficiency, base on the nominal level of inherent risk, we affirm our belief that such deficiency was not significant enough to warrant the conclusion that our work was insufficient to support our opinion.

- **Our conclusion**

Based on our understanding of the fundamental principles of risk-based auditing and applicable professional standards and our risk assessment process as applied, materiality judgments and related conclusions reached in this audit, we believe that audit risk regarding the revenue-related assertions in this client's financial statements was reduced to an acceptably low level to support the expression of our unqualified opinion on the financial statements of Issuer C. Accordingly, we hereby request that the Board reconsider and withdraw its conclusions regarding this matter and this engagement, and we believe no further action is necessary to comply with AU 390.

MATTER 4 (Subparagraph (3) of PART I.A)

This matter (identified in Part II of the Board's draft report as section A3a) that is characterized as a significant deficiency in subparagraph (3) of PART I.A of the draft report relates to a question as to the adequacy of our evaluation of the recoverability of an intangible asset, technology rights, the most significant asset in Issuer C's balance sheet, and our documentation thereof.

- **What was in our workpapers?**

The comment in Part II, section A3a, of the Board's draft report states, without qualification, that our "work papers do not include an evaluation of the recoverability of the issuer's intellectual property …." However, as the Board's inspector was aware, we had a file memorandum documenting our evaluation and judgment (which we believed adequately met the applicable professional standards, including the documentation objectives contained in PCAOB AS 3) stating that even though the issuer "has had a brief history of losses, and has been receiving going concern language in our reports, it is barely out of the development stage and the prospects for raising sufficient capital to successfully bring its products to market appear to be good. Product development is substantially complete, and the marketing plan is just being developed …." As documented in our 2004 file memorandum, our current evaluation was based on verified information about a significant recently executed distribution agreement associated with marketing activity expected to produce significant sales in a new foreign market , a significant sales contract then under negotiation with the U.S. Defense Department also considered likely to produce significant revenue and recent favorable product testing results.

In this case, the technology rights in the balance sheet were acquired only a short time ago (in April 2003) in an arms' length negotiated transaction. In determining the value of the technology at that time, the board of directors estimated the future income potential of the acquired technology by analyzing potential applications and identifiable likely markets for the technology. Details of these considerations are documented in our 2003 workpapers, which were not requested or examined by the Board's inspectors. We ascertained in our 2004 audit and documented in the file memorandum examined by the inspectors that no unexpected, adverse events or changes in circumstances occurred since that acquisition transaction, and that marketing activities were just beginning to show results.

Our documented conclusion was that there was only a remote chance of a material financial statement misstatement in the form of an unrecorded impairment writedown and, for reasons discussed below, that neither a cash flow forecasting exercise nor a formal update of the 2003 valuation was necessary in the circumstances.

- **What should be the effect of a going concern report modification?**

We understand that inclusion of going concern language in an audit report may indicate a need for an issuer to assess recoverability of long-lived assets under SFAS 144 on a going concern basis, and that whenever appropriate, similarly, auditors must then evaluate and apply audit procedures to management's assertions about recoverability of long-lived assets as deemed necessary in the circumstances. However, we do not believe that the auditor's obligation to report a going concern uncertainty necessarily translates into a condition that triggers an issuer's obligation to prepare, and an auditor's obligation to review, a cash flow forecast or formal fair value estimate under SFAS 144 (see next paragraph).

MATTER 4 (continued)

What is the issuer's obligation under GAAP?

Since this asset is a limited life intangible subject to amortization, it is subject to impairment evaluation and accounting under SFAS 144. Paragraph 8 of SFAS 144 states that impairment writedowns should be considered "whenever ***events or changes in circumstances*** [commonly called "triggering" conditions] indicate that the carrying amount of the asset may not be recoverable" [emphasis added]. The linking of the need to consider impairment to an event or change in circumstances (including a plan of disposal) is further discussed and reinforced briefly in paragraphs B16 and B17.

We believe it is normal and to be expected in the early stages of building a new business, especially when based on emerging technology, to make investments in long-lived assets and to incur operating expenses that exceed revenues and negative cash flows, sometimes for many years. We also believe that the so-called "triggering" conditions described in SFAS 144 such as the kinds observed in this case, that would ordinarily tend to signal a downward trend, for example, for a business that already has a substantial operating history, do not, on the other hand, necessarily constitute "events or changes in circumstances" or, therefore, have the same significance, for companies barely out of the development stage.[6] Since such conditions are normal and expected for businesses in their early stages, they do not present a reason for diminished optimism as compared to that which was present when the investment was first made or committed to be made, especially when there are tangible signs of encouragement and product acceptance on the horizon. Moreover, many positive signs or indicators such as were observed in this case are often not readily quantifiable for incorporation into reasonably reliable cash flow forecasts. Nevertheless, we were convinced that even had a cash flow forecast been prepared that showed a need to proceed with a recoverability test, SFAS 144 provides that a writedown would be required only to estimated fair value based on a presumed arm's length sale of the asset , if less than the carrying value. As discussed above, the issuer's board of directors made such valuation estimates, based in part on future cash flow estimates, when the technology rights were acquired only 20 months prior to the audit date.

The reasons the issuer has not received positive cash flows from the technology to date have more to do with a lack of resources for marketing than with any inherent flaw in the technology or lack of market acceptance, interest or perceived potential demand for its products. On the contrary, as noted in our workpapers and discussed above, all apparent indications were that such things are on the rise and that a new fair value estimate would likely exceed its current amortized carrying value, thus producing no impairment writedown.

- **What does hindsight show now?**

For your information, Issuer C reported a 61% increase (albeit modest in absolute dollars) in revenues from product sales for 2005, consistent with expectations at the time of our 2004 audit, but the related gross profit was more than offset by increased selling, general and administrative expenses, and operating cash flows declined. Nevertheless, as a result of capital transactions, the issuer's financial condition improved, and we were able to exclude the going concern language from our report on 2005. More significantly, as expected, in its 2005 report on Form 10-KSB, the issuer was able to forecast product sales increases approximating 300% for 2006 and further for 2007, based on minimum purchase commitments already received from its customers, and it showed and substantial operating profit in the first quarter of 2006 resulting from significant increases in sales.

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[6] Other events or changes in circumstances could signal a significant downtrend with regard to a business still under development but ordinarily not these.

MATTER 4 (continued)

Our conclusion

We believe the statement made in the Board's draft report relative to this matter (in Part II, section A3a), *i.e.*, that we "should have performed and documented procedures to determine whether the recorded value of the assets was impaired," incorrectly suggests that there was a burden on the issuer under SFAS 144 to assess recoverability (which it did anyway) and incorrectly implies that we did not perform and document appropriate audit procedures (which we did). As a result, we believe that such statement in the Board's draft report should be reconsidered and withdrawn. Although we believe our work and our documentation in this area was, in fact, in compliance with all applicable professional standards (including PCAOB AS 3), adequate and appropriate in the circumstances, nevertheless, following our intense re-examination of the issue, we have instructed the engagement personnel to expand the documentation pursuant to the guidance in PCAOB AS 3 to better support our conclusions, and such additional documentation is now in the process of being reviewed. Based on our careful assessment, we do not believe any further action, however, is necessary to comply with AU 390.

A BRIEF SUMMARY OF BASIC GENERAL PRINCIPLES OF RISK-BASED AUDIT SCOPE DETERMINATION

In defense of our positions regarding audit scope decisions made by our auditors that were challenged by the Board's inspectors and included in its draft report, we believe it is necessary to demonstrate, in the brief summary that appears below, our understanding of certain basic principles of modern financial auditing, particularly as to the use of auditor judgments in scope determination, offered in further explanation of the rationale applied in the inspected engagements

One of our principals, who has had almost 40 years of SEC audit practice experience and the rare distinction of serving our profession as a former member of two senior standard-setting committees of the AICPA, its ASB and Accounting Standards Executive Committee, is one the primary developers of our risk-based methodology, used by thousands of auditors in many firms in the U.S. and around the world. (As evidence of our firm's unusually high commitment to quality when compared to other firms our size, this individual is engaged full time in quality control activities.)

Following is a brief summary of our understanding of the basic principles of audit scope determination applied in our risk-based approach in all our audit engagements:

- Primarily through SAS 47 (AU 312), auditing standards have long established that audit risk considerations are equally as important as materiality in determining appropriate audit scope, that the most critical judgments in scope determination were not limited just to what is material, but rather what bears a risk of being materially misstated. There are very few audit procedures that are expressly mandated by professional standards for universal application in all audits. According to Carmichael, *et al*, "A risk-based audit requires the audit approach to be flexible. The auditor has to make judgments about the type of procedures that are necessary to address specific risks identified."[7]

- In specific reference to the audit risk model or formula first introduced solely in the context of audit sampling in SAS 39 (AU 350), which was effectively extended to the audit, as a whole, and all of its parts, by AU 312, an auditor considers first the risk of occurrence of a material misstatement (inherent risk) and then selects the scope of substantive testing with the judgmentally determined detection risk level necessary to reduce the risk of issuing an inappropriate opinion on the financial statements (audit risk) to an acceptably low level (possibly considering the extent, if any, to which a mitigating control risk assessment, provided it is supported by planned internal control tests, might enable use of a detection risk that is higher than otherwise and, therefore, a reduced scope of substantive testing). As a result, even a material financial statement item may be subjected to minimal testing, for example, if the inherent risk of material misstatement is judged to be low, and conversely, an apparently immaterial amount may warrant substantial audit effort when the auditor perceives significant inherent risk as to understatement (completeness).

- An auditor may achieve the desired level of detection risk by selecting substantive tests of details applied, to a greater or lesser degree (smaller or larger sample sizes, for example, under the guidance provided by AU 350), to classes of transactions or account balances, or substantive analytical procedures (pursuant to SAS 56 (AU 329), as amended in September 2004 by PCAOB Release 2004-008) or more often, a combination thereof, for each financial statement assertion perceived to possess significant inherent risk.

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[7] *Op cit.*, para. 101.12.

APPENDIX

FREQUENTLY USED ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
AS	Auditing Standards (issued by PCAOB)
ASB	Auditing Standards Board (of AICPA)
FASB	Financial Accounting Standards Board
IAS	International Accounting Standard (issued by IASB or IASC)
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee (predecessor to IASB)
PCAOB	Public Company Accounting Oversight Board
SAP	Statement on Auditing Procedures (predecessor standards to SASs)
SAS	Statement on Auditing Standards (issued by ASB)
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards (issued by FASB)

END OF RESPONSE TO PART I OF DRAFT INSPECTION REPORT