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Report on

2014 Inspection of MaloneBailey, LLP

(Headquartered in Houston, Texas)

Issued by the

Public Company Accounting Oversight Board

July 30, 2015

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. 104-2015-177A
(Includes portions of Part II of the full report that
were not included in PCAOB Release No. 104-2015-177)

PCAOB Release No. 104-2015-177A

PCAOB
Public Company Accounting Oversight Board

2014 INSPECTION OF MALONEBAILEY, LLP

Preface

In 2014, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm MaloneBailey, LLP ("Malone" or "the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.D of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included reviews of portions of selected issuer audits. These reviews were intended to identify whether deficiencies existed in the reviewed work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report, portions of Appendix A, and Appendix B. Appendix A consists of the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the Firm's system of quality control, those discussions also could eventually be made public, but only to the extent the Firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report. Appendix B presents the text of the paragraphs of the auditing standards that are referenced in Part I.A. in relation to the description of auditing deficiencies there.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the inspection team") conducted primary procedures[1] for the inspection from July 14, 2014 through July 25, 2014. The inspection team performed field work at the Firm's headquarters in Houston, Texas.

A. Review of Audit Engagements

The inspection procedures included reviews of portions of 10 issuer audits performed by the Firm. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed.

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix B to this report. The references in this sub-Part include only standards that primarily relate to the deficiencies; they do not present a comprehensive list of every auditing standard that applies to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in the references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

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[1] For this purpose, the time span for "primary procedures" includes field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. The time span does not include (1) inspection planning, which may commence months before the primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which generally extend beyond the primary procedures.

Certain of the deficiencies identified were 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 that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework and/or its opinion about whether the issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR.

The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are misstated or that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.[2]

[2] Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Depending upon the circumstances, compliance with PCAOB standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure by a firm to take appropriate actions, or a firm's misrepresentations in responding to an inspection report about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

The audit deficiencies that reached this level of significance are described in Part I.A.1 through I.A.6, below.

Effects on Audit Opinions

Of the six issuer audits that appear in Part I.A, a deficiency in one audit relates to testing controls for purposes of the ICFR opinion and deficiencies in five audits relate to the substantive testing performed for purposes of the opinion on the financial statements, as noted in the table below.

	Number of Audits
Deficiencies included in Part I.A related to both the financial statement audit and the ICFR audit	-
Deficiencies included in Part I.A related to the financial statement audit only	5
Deficiencies included in Part I.A related to the ICFR audit only	1
Total	6

Most Frequently Identified Audit Deficiencies

The following table lists, in summary form, the types of deficiencies that are included most frequently in Part I.A of this report. A general description of each type is provided in the table; the description of each deficiency in Part I.A contains more specific information about the individual deficiency. The table includes only the two most frequently identified deficiencies that are in Part I.A of this report and is not a summary of all deficiencies in Part I.A.

Deficiencies	Part I.A Audits
Failure to perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	5 Audits: Issuers A, B, C, E and F

Deficiencies	Part I.A Audits
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	<u>3 Audits:</u> Issuers A, B, and C

Audit Deficiencies

A.1. <u>Issuer A</u>

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- The Firm failed to perform sufficient procedures to test the issuer's acquisition of substantially all of the assets and certain liabilities of a related party. Specifically, beyond making inquiries of management and comparing the five-year cash-flow projections to actual results, the Firm failed to evaluate the reasonableness of the significant assumptions, including the potential effect of a known contingency, used by the issuer in estimating cash flow projections in determining the fair values of the acquired intangible assets and certain liabilities at the date of acquisition. In addition, the Firm failed to evaluate whether the subsequent resolution of the contingency after the acquisition date represented information that should have been considered in the measurement of the amounts recognized as of the acquisition date in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 805, *Business Combinations*. (AU 328, paragraphs .26 and .28)

- The Firm failed to perform sufficient procedures to test the occurrence and valuation of revenue. Specifically –

  - The Firm haphazardly selected a sample of revenue transactions to test the occurrence and valuation of revenue. The Firm failed, in determining its sample size, to consider appropriate factors, including its established tolerable misstatement, the allowable risk of incorrect acceptance based on the assessed risk of material misstatement, and the characteristics of the population of revenue. As a result, the sample size was too small to achieve the planned objective of the test. (AU 350, paragraphs .23 and .23A) In addition, in testing the selected items, the Firm used issuer-produced customer billing statements as evidence to determine whether revenue was properly recognized; however, the Firm failed to test the accuracy and completeness of the issuer-produced customer billing statements. (AS No. 15, paragraph 10)

- The Firm performed yearly comparisons of sales volumes, revenue, and gross margins; however, the Firm failed to (i) develop expectations that were precise enough to provide the necessary degree of assurance that potential material misstatements would be identified, (ii) evaluate the reasonableness of the issuer's explanation for significant unexpected differences, and perform procedures to obtain corroboration for such explanations identified in the execution of these comparisons, and (iii) test the accuracy and completeness of the sales volume data used in the comparison of sales volume. (AU 329, paragraphs .16, .17, and .21)

A.2. Issuer B

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- The Firm failed to perform sufficient procedures to test the occurrence and valuation of revenue by haphazardly selecting a sample of revenue transactions to test these assertions. Specifically, the Firm failed, in determining its sample size, to consider appropriate factors, including its established tolerable misstatement, the allowable risk of incorrect acceptance based on the assessed risk of material misstatement, and the characteristics of the population of revenue. As a result, the sample size was too small to achieve the planned objective of the test. (AU 350, paragraphs .23 and .23A)

- The Firm failed to perform sufficient procedures to test the valuation of inventory. Specifically, the Firm tested the issuer's labor and overhead costs in the aggregate; however, it failed to perform procedures to evaluate the significant assumptions related to the allocation of such costs to the various pools of work-in-process and finished goods inventory including (i) the standard labor rate, (ii) the manufacturing allocation rate, (iii) the labor cost allocation rate, and (iv) the completion rate of work-in-process inventory. (AU 342, paragraph .11)

A.3. Issuer C

In this audit, the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements –

- The Firm failed to perform sufficient procedures to test the valuation of capitalized costs of a long-lived asset. Other than inquiries of management, the Firm failed to performed procedures to evaluate whether the capitalized costs were in excess of net realizable value. (AU 342, paragraphs .04 and .07)

- The Firm failed to perform sufficient procedures to test the valuation of an asset of the issuer that was required to be transferred to a lender as part of a loan arrangement. Specifically, the Firm failed to perform procedures to evaluate whether the historical carrying value of the transferred asset approximated its fair value. (AU 328, paragraphs .03 and .15)

A.4. Issuer D

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the effectiveness of ICFR, as its procedures to test the operating effectiveness of controls over the occurrence of revenue were insufficient. Specifically, the Firm identified four important controls over the occurrence of revenue, including three controls that had review aspects. The fourth control operated over journal entries and over the information used in the performance of these three controls with review aspects. The Firm inappropriately limited its testing of the operating effectiveness of this fourth control to observing initials on the journal entry voucher indicating the control operated and failed to test whether the control operated as intended. (AS No. 5, paragraphs 42 and 44)

A.5. Issuer E

The issuer had arrangements to outsource the manufacturing of all of its products. The outside manufacturers either directly shipped the products to the issuer's customers or transferred the finished products to a public warehouse. The Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as its procedures to test the occurrence, completeness, and valuation of revenue were insufficient. Specifically –

- The Firm failed, beyond inquiries of management, to perform procedures to determine whether there were any arrangements or contracts between the issuer, the outsourced manufacturers, and the issuer's customers that could affect the issuer's revenue recognition. (AS No. 13, paragraphs 8 and 13)

- The issuer disclosed that it incurred sales discounts and promotions, and other fees that were netted against reported revenue. The Firm failed to perform any procedures to (1) obtain an understanding of, and evaluate, the terms of these programs and arrangements and (2) test the amount of such costs incurred related to these programs and arrangements. (AS No. 13, paragraphs 8 and 13)

- The Firm failed to perform procedures to test other revenue. (AS No. 12 paragraph 59, AS No. 13, paragraphs 8 and 36)

A.6. Issuer F

In this audit, the Firm failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements, as its procedures to test the occurrence and valuation of revenue were insufficient. Specifically, although the Firm identified a fraud risk related to revenue, other than performing tests of details on all revenue transactions above a certain amount in one category of revenue and on the three largest revenue transactions in a second category of revenue, the Firm failed to perform any substantive procedures, including tests of details, that were specifically responsive to the assessed risk in the remaining portion of revenue. (AS No. 13, paragraphs 8 and 13; AS No. 15, paragraph 27)

B. Auditing Standards

Each deficiency described in Part I.A above could relate to several provisions of the standards that govern the conduct of audits. The paragraphs of the standards that are cited for each deficiency are those that most directly relate to the deficiency. The deficiencies also relate, however, to other paragraphs of those standards and to other auditing standards, including those concerning due professional care, responses to risk assessments, and audit evidence.

Many audit deficiencies involve a lack of due professional care. AU 230, *Due Professional Care in the Performance of Work*, paragraphs .02, .05, and .06 requires the independent auditor to plan and perform his or her work with due professional care and sets forth aspects of that requirement. AU 230, paragraphs .07 through .09 and AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 7 specify that due professional care requires the exercise of professional skepticism. These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13, paragraphs 3, 5, and 8 requires the auditor to design and implement audit responses that address the risks of material misstatement. AS No. 15, *Audit Evidence* paragraph 4 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 (in the audit of financial statements) or the risk associated with the control (in the audit of ICFR) 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 providing support for the related conclusions.

The paragraphs of the standards that are described immediately above are not cited in Part I.A, unless those paragraphs are the most directly related to the relevant deficiency.

B.1. List of Specific Auditing Standards Referenced in Part I.A

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited. For each auditing standard, the table also provides the number of distinct deficiencies for which the standard is cited for each of the relevant issuer audits. This information identifies only the number of times that the standard is referenced, regardless of whether the reference includes multiple paragraphs or relates to multiple financial statement accounts.

PCAOB Auditing Standards	**Audits**	**Number of Deficiencies per Audit**
AS No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*	Issuer D	1
AS No. 12, *Identifying and Assessing Risks of Material Misstatement*	Issuer E	1
AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	Issuer E Issuer F	3 1
AS No. 15, *Audit Evidence*	Issuer A Issuer F	1 1
AU 328, *Auditing Fair Value Measurements and Disclosures*	Issuer A Issuer C	1 1
AU 329, *Substantive Analytical Procedures*	Issuer A	1
AU 342, *Auditing Accounting Estimates*	Issuer B Issuer C	1 1
AU 350, *Audit Sampling*	Issuer A Issuer B	1 1

B.2. Financial Statement Accounts or Auditing Areas Related to Identified Audit Deficiencies

The table below lists the financial statement accounts or auditing areas related to each deficiency included in Part I.A of this report and identifies the audits described in Part I.A where deficiencies relating to the respective areas were observed.[3]

	AS No. 5	AS No.12	AS No. 13	AS No.15	AU 328	AU 329	AU 342	AU 350
Business combinations					A			
Capitalized costs							C	
Inventory							B	
Revenue	D	E	E, F	A, F		A		A, B
Transfer of an asset					C			

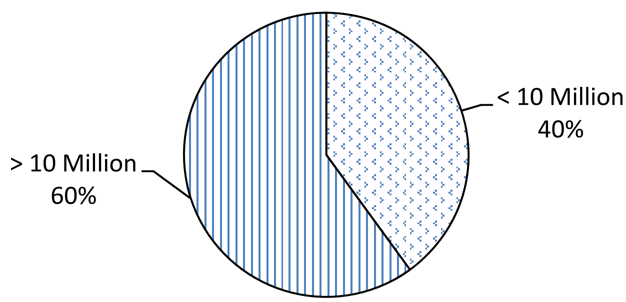
C. Data Related to the Issuer Audits Selected for Inspection

C.1 Revenue Ranges of Issuers Inspected

The chart below categorizes, based upon revenue, the 10 issuers whose audits were inspected in 2014.[4] This presentation of revenue data is intended to provide information about the size of issuer audits that were inspected and is not indicative of whether the inspection included a review of the Firm's auditing of revenue in the issuer audits selected for review.

[3] Certain deficiencies that affect multiple accounts or areas, such as those related to scoping multi-location audits and those related to the evaluation of control deficiencies, are excluded from this table, but are included in appendix B.

[4] The revenue amounts reflected in the chart are for the issuers' fiscal year end that corresponds to the audit inspected by the PCAOB. The revenue amounts were obtained from S&P and reflect a standardized approach to presenting revenue amounts.



Revenue Ranges of Issuers Inspected

Revenue	Number of Audits Inspected	Percentage
< 10 Million	4	40%
> 10 Million	6	60%

D. Information Concerning PCAOB Inspections that is Generally Applicable to Annually Inspected Firms

Board inspections include reviews of certain portions of selected audit work performed by the inspected firm and reviews of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the Firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

D.1. Reviews of Audit Work

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of ICFR. For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[5] as well as a firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection of an annually inspected firm does not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS No. 3, *Audit Documentation*, 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

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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 the applicable financial reporting framework, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the 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.

other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, an inspection team considers whether audit documentation or any other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[6]

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

D.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* provides that an auditing firm has a responsibility to ensure that its personnel

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[6] The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audits. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion or a failure to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in an audit may indicate a defect or potential defect in a firm's quality control system.[7] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[8] related firm methodology, guidance, and practices; and possible root causes.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control

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7 Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report does not discuss every audit deficiency the inspection team identified.

8 An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

system. The inspection team customizes the procedures it performs with respect to the firm's practices, policies, and processes related to audit quality, bearing in mind the firm's structure, procedures performed in prior inspections, past and current inspection observations, an assessment of risk related to each area, and other factors. The areas generally considered for review include (1) management structure and processes, including the tone at the top; (2) practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission, and disciplinary actions; (3) policies and procedures for considering and addressing the risks involved in accepting and retaining issuer audit engagements, including the application of the firm's risk-rating system; and (4) the firm's processes for monitoring audit performance, including processes for identifying and assessing indicators of deficiencies in audit performance, independence policies and procedures, and processes for responding to defects or potential defects in quality control. A description of the procedures generally applied to these areas is below.

D.2.a. Review of Management Structure and Processes, Including the Tone at the Top

Procedures in this area are designed to focus on (1) how management is structured and operates the firm's business, and the implications that the management structure and processes have on audit performance, and (2) whether actions and communications by the firm's leadership – the tone at the top – demonstrate a commitment to audit quality. To assess this area, the inspection team may interview members of the firm's leadership and review significant management reports and documents, as well as information regarding financial metrics and other processes that the firm uses to plan and evaluate its business.

D.2.b. Review of Practices for Partner Management, Including Allocation of Partner Resources and Partner Evaluation, Compensation, Admission, and Disciplinary Actions

Procedures in this area are designed to focus on (1) whether the firm's processes related to partner evaluation, compensation, admission, termination, and disciplinary actions could be expected to encourage an appropriate emphasis on audit quality and technical competence, as distinct from marketing or other activities of the firm; (2) the firm's processes for allocating its partner resources; and (3) the accountability and responsibilities of the different levels of firm management with respect to partner management. The inspection team may interview members of the firm's management and review documentation related to certain of these topics. In addition, the inspection team's evaluation may include the results of interviews of audit partners regarding their responsibilities and allocation of time. Further, the inspection team may review a sample of partners' personnel files.

D.2.c. Review of Policies and Procedures for Considering and Addressing the Risks Involved in Accepting and Retaining Issuer Audit Engagements, Including the Application of the Firm's Risk-Rating System

The inspection team may consider the firm's documented policies and procedures in this area. In addition, the inspection team may select certain issuer audits to (1) evaluate compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing the issuer audit engagements and (2) observe whether the audit procedures were responsive to the risks identified during the process.

D.2.d. Review of a Firm's Processes for Monitoring Audit Performance, Including Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance, Independence Policies and Procedures, and Processes for Responding to Defects or Potential Defects in Quality Control

D.2.d.i. Review of Processes for Identifying and Assessing Indicators of Deficiencies in Audit Performance

Procedures in this area are designed to identify and assess the monitoring processes that the firm uses to monitor audit quality for individual engagements and for the firm as a whole. The inspection team may interview members of the firm's management and review documents relating to the firm's identification, and evaluation of, and response to, possible indicators of deficiencies in audit performance. In addition, the inspection team may review documents related to the design, operation, and evaluation of findings of the firm's internal inspection program, and may compare the results of its review of audit work to those from the internal inspection's review of the same audit work.

D.2.d.ii. Review of Response to Defects or Potential Defects in Quality Control

The inspection team may review steps the firm has taken to address possible quality control deficiencies and assess the design and effectiveness of the underlying processes. In addition, the inspection team may inspect audits of issuers whose audits had been reviewed during previous PCAOB inspections of the firm to ascertain whether the audit procedures in areas with previous deficiencies have improved.

D.2.d.iii. Review of Certain Other Policies and Procedures Related to Monitoring Audit Quality

The inspection team may assess policies, procedures, and guidance related to aspects of independence requirements and the firm's consultation processes, as well as the firm's compliance with these requirements and processes. In addition, the inspection team may review documents, including certain newly issued policies and procedures, and interview firm management to consider the firm's methods for developing audit policies, procedures, and methodologies, including internal guidance and training materials.

END OF PART I

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

PART II

ISSUES RELATED TO QUALITY CONTROLS

This Part II contains a discussion of criticisms of and potential defects in the Firm's quality control system.[9] As described below, an analysis of the inspection results reported by the inspection team, including the results of the reviews of individual audits, indicates that the Firm's system of quality control requires remedial action in order to provide sufficient assurance that the Firm's audit work will meet applicable standards and requirements.

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Deficiencies in the System of Quality Control Related to the Application of Due Care, Including Professional Skepticism

The application of due care, including professional skepticism is essential to the performance of effective audits under PCAOB standards, and a lack of due care can have a pervasive effect on an audit. The inspection results indicate that the Firm's system of quality control appears not to provide reasonable assurance that the Firm's professionals will appropriately exercise due care, including professional skepticism in the performance of issuer audits. The inspection team identified five audits[10] with deficiencies that appear to be caused, at least in part, by the failure to appropriately exercise due care, including professional skepticism, all of which are described in Part I.A of this report. In two of these five audits[11] these deficiencies occurred in areas where

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[9] This report's description of quality control issues is based on the inspection team's observations during the primary inspection procedures. Any changes or improvements that the Firm may have made in its system of quality control since that time may not be reflected in this report, but will be taken into account by the Board during the 12-month remediation process following the issuance of this report.

[10] Issuers A, B, C, D, and F

[11] Issuers A and F

the Firm had identified one or more fraud risks. In three of these five audits,[12] with deficiencies related to testing an acquisition, capitalized costs, inventory valuation, and the valuation of a transferred asset, the Firm failed to critically assess the reasonableness of management's estimates. In one of these five audits,[13] with deficiencies related to testing controls, the Firm failed to perform sufficient procedures as it limited its testing of the operating effectiveness of a control to observing initials on the journal entry voucher and failed to test whether the control operated as intended.

The Firm should identify and evaluate the root causes of the recurring deficiencies in this area. As part of this assessment, the Firm should (1) evaluate whether engagement teams have placed sufficient emphasis on applying due care, including professional skepticism when responding to identified fraud risks, (2) assess the reasons for engagement teams' failures to appropriately exercise due care, including professional skepticism, when auditing accounting estimates, (3) assess the reasons for engagement teams' failure to obtain appropriate audit evidence, and (4) seek to understand why the guidance, training, communications, and tools that the Firm has provided were not effective in preventing the deficiencies noted in this section. Following these actions, the Firm should implement, and monitor the effectiveness of, appropriate modifications or enhancements to its system of quality control.

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[12] Issuers A, B, and C

[13] Issuer D

APPENDIX A

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[14]

[14] 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.

malonebailey LLP
CERTIFIED PUBLIC ACCOUNTING FIRM

June 11, 2015

Ms. Helen Munter
Director
Division of Registration and Inspections
1666 K Street NW, suite 800
Washington, DC 20006

Re: Public Response to Part I of the Draft Report on the 2014 Inspection of MaloneBailey LLP

Dear Ms. Munter:

We are pleased to provide our response to the Public Company Accounting Oversight Board's ("PCAOB") report on the 2014 inspection of MaloneBailey LLP dated May, 11, 2015 (the "Draft Report"). We support the PCAOB inspection process to help us identify areas where we may improve our audit performance. We believe the inspection process is a fundamental mission of the PCAOB and intend to use the process to identify areas where we should improve and enhance our audit quality.

We have evaluated each of the matters described in Part I of the Draft Report. In that regard, we have considered whether it was necessary to perform additional procedures in accordance with AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Fasts Existing at the Date of the Auditor's Report* and, where appropriate, performed such procedures.

We remain committed to improving our audit performance and underlying quality control systems. We appreciate the opportunity to respond to the report and look forward to future constructive dialogue.

Sincerely,

MaloneBailey, LLP

Malone Bailey LLP

Attachment: Non-public addendum

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NEXIA INTERNATIONAL

APPENDIX B

AUDITING STANDARDS REFERENCED IN PART I

This Appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this Appendix, and any other Notes, are from the original auditing standards that are referenced. While this Appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at http://pcaobus.org/STANDARDS/Pages/default.aspx.

AS No. 5, ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***		
TESTING CONTROLS		
Testing Design Effectiveness		
AS No. 5.42	The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.	Issuer D
Testing Operating Effectiveness		
AS No. 5.44	The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.	Issuer D

AS No. 12, *Identifying and Assessing Risks of Material Misstatement*		
IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT		
AS No. 12.59	The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should: a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4–58) and considering the characteristics of the accounts and disclosures in the financial statements. Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65–69 of this standard. b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions. c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level. d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[32/] e. Identify significant accounts and disclosures[33/] and their relevant assertions[34/] (paragraphs 60–64 of this standard). Note: The determination of whether an	Issuer E

AS No. 12, *Identifying and Assessing Risks of Material Misstatement*

	account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls. f. Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70–71 of this standard).	

Footnotes to AS No. 12.59

[32/] Paragraphs 16–35 of Auditing Standard No. 13.

[33/] Paragraph A10 of Auditing Standard No. 5 states:

An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

[34/] Paragraph A9 of Auditing Standard No. 5 states:

A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Responses Involving the Nature, Timing, and Extent of Audit Procedures		
AS No. 13.8	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers E and F
RESPONSES TO FRAUD RISKS		
AS No. 13.13	*Addressing Fraud Risks in the Audit of Financial Statements*. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the	Issuers E and F

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*		
	assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.	
TESTING CONTROLS IN AN AUDIT OF FINANCIAL STATEMENTS		
Substantive Procedures		
AS No. 13.36	The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.	Issuer E

AS No. 15, *Audit Evidence*		
Sufficient Appropriate Audit Evidence		
USING INFORMATION PRODUCED BY THE COMPANY		
AS No. 15.10	When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[3/] • Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and • Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.	Issuer A

Footnote to AS No. 15.10

[3/] When using the work of a specialist engaged or employed by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, see Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AS No. 15, *Audit Evidence*		
SELECTING SPECIFIC ITEMS		
AS No. 15.27	The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[12/]	Issuer F
Footnote to AS No. 15.27 [12/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.		

AU 328, *Auditing Fair Value Measurements and Disclosures*		
Introduction		
AU 328.03	The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." [fn 1] Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.	Issuer C
Footnote to AU 328.03 [fn 1] Generally accepted accounting principles (GAAP) contain various definitions of fair value. However, all of the definitions reflect the concepts in the definition that appears in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. For example, Governmental Accounting Standards Board Statement of Governmental Accounting Standards No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, defines fair value as "the amount at which an investment could		

AU 328, *Auditing Fair Value Measurements and Disclosures*		
be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."		
Evaluating Conformity of Fair Value Measurements and Disclosures with GAAP		
AU 328.15	The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. The auditor's understanding of the requirements of GAAP and knowledge of the business and industry, together with the results of other audit procedures, are used to evaluate the accounting for assets or liabilities requiring fair value measurements, and the disclosures about the basis for the fair value measurements and significant uncertainties related thereto.	Issuer C
Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data		
AU 328.26	The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether: a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06). b. The fair value measurement was determined using an appropriate model, if applicable. c. Management used relevant information that was reasonably available at the time.	Issuer A
AU 328.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.	Issuer A

AU 329, *Substantive Analytical Procedures*		
Analytical Procedures Used as Substantive Tests		
Availability and Reliability of Data		
AU 329.16	Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives: • Whether the data was obtained from independent sources outside the entity or from sources within the entity • Whether sources within the entity were independent of those who are responsible for the amount being audited • Whether the data was developed under a reliable system with adequate controls • Whether the data was subjected to audit testing in the current or prior year • Whether the expectations were developed using data from a variety of sources	Issuer A
Precision of the Expectation		
AU 329.17	The expectation should be precise enough to provide the desired level of assurance that differences that may be	Issuer A

AU 329, *Substantive Analytical Procedures*		
	potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.	
Investigation and Evaluation of Significant Differences		
AU 329.21	The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, Evaluating Audit Results.)	Issuer A

AU 342, *Auditing Accounting Estimates*		
AU 342.04	The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.	Issuer C

AU 342, *Auditing Accounting Estimates*		
Evaluating Accounting Estimates		
AU 342.07	The auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate evidential matter to provide reasonable assurance that— a. All accounting estimates that could be material to the financial statements have been developed. b. Those accounting estimates are reasonable in the circumstances. c. The accounting estimates are presented in conformity with applicable accounting principles [fn 2] and are properly disclosed. [fn 3]	Issuer C
Footnote to AU 342.07 fn 2 Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.] fn 3 See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.		
Evaluating Reasonableness		
AU 342.11	Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach: a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests. c. Consider whether there are additional key factors or alternative assumptions about the factors.	Issuer B

AU 342, *Auditing Accounting Estimates*		
	d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose. f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions. g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. h. Consider using the work of a specialist regarding certain assumptions (section 336, Using the Work of a Specialist). i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.	

AU 350, *Audit Sampling*		
Sampling In Substantive Tests Of Details		
Planning Samples		
AU 350.23	To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.	Issuers A and B
AU 350.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach.	Issuers A and B

AU 350, *Audit Sampling*		
	When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	