PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8433
www.pcaobus.org

Report on

2014 Inspection of Kabani & Company, Inc.
(Headquartered in Los Angeles, California)

Issued by the

Public Company Accounting Oversight Board

April 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. 104-2015-116

PCAOB Release No. 104-2015-116

2014 INSPECTION OF KABANI & COMPANY, INC.

Preface

In 2014, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Kabani & Company, Inc. ("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.C of this report (which also contains additional information concerning PCAOB inspections generally). Overall, the inspection process included reviews of portions of selected issuer audits completed by the Firm. These reviews were intended to identify whether deficiencies existed in those portions of the inspected audits, 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 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. 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.

PROFILE OF THE FIRM[1]

Number of offices	1 (Los Angeles, California)
Ownership structure	Professional corporation
Number of partners	2
Number of professional staff[2]	18
Number of issuer audit clients	10

[1] The information presented here is as understood by the inspection team, generally as of the outset of the inspection, based on the Firm's self-reporting and the inspection team's review of certain information. Additional information, including additional detail on audit reports issued by the Firm, is available in the Firm's filings with the Board, available at http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx.

[2] 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.

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from May 19, 2014 to May 23, 2014.[3]

A. Review of Audit Engagements

The inspection procedures included a review of portions of three 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 A 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 any 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.

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. In other words, in these audits, the auditor issued an

---

[3] For this purpose, "primary procedures" include 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. Primary procedures do not include (1) inspection planning, which is performed prior to primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which extend beyond the primary procedures.

opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement.

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. 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.[4]

The audit deficiencies that reached this level of significance are described below –

Issuer A

the failure to perform sufficient procedures to evaluate the issuer's recognition of certain income (AS No. 14, paragraphs 30 and 31).

Issuer B

the failure to perform sufficient procedures to evaluate the appropriateness of the capitalization of certain costs (AS No. 14, paragraph 30).

---

[4] 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 the inspections staff may include in its procedures monitoring or assessing a firm's compliance.

B. Auditing Standards

Each deficiency described above could relate to several applicable provisions of the standards that govern the conduct of audits, including both the paragraphs of the standards that are cited at the end of each description of the deficiency included in Part I.A of this report and one or more of the specific paragraphs discussed below.

Many audit deficiencies involve a lack of due professional care. AU 230, *Due Professional Care in the Performance of Work* ("AU 230"), 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 Auditing Standard ("AS") No. 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS No. 13"), 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, and 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) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in support of the related conclusions.

The table below lists the specific auditing standards that are referenced for each deficiency included in Part I.A of this report. See the descriptions of the deficiencies in Part I.A for identification of the specific paragraphs, in addition to those noted above, that relate to the individual deficiencies.

PCAOB Auditing Standards	Issuers
AS No. 14, *Evaluating Audit Results*	A and B

C. Information Concerning PCAOB Inspections Generally Applicable to Triennially 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 audits 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.

C.1. Reviews of Audit Work

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of internal control over financial reporting ("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 failures to perform, or to perform sufficiently, certain necessary audit procedures. The inspection may not involve the review of all of a 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* ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion, must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, the inspection team considers whether audit documentation or any persuasive other evidence that a firm might provide to the inspection team supports a 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.

---

[5] When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with applicable accounting principles, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to 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.

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.

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

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

---

[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.

an insufficiently supported audit opinion 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 system. This review addresses practices, policies, and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures.

END OF PART I

[7] Not every audit deficiency suggests a defect or potential defect in a firm's quality control system.

[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.

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

PART IV

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[9]

[9] 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.

KABANI & COMPANY, INC.
Certified Public Accountants
5757 West Century Blvd., Suite 303, Los Angeles, CA 90045

Phone (310) 568-1625
Fax (310) 410-0371
www.kabanico.com

February 26, 2015

Ms. Helen A. Munter
Director - Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Response to Part I of Public Company Accounting Oversight Board (PCAOB) Draft Report on 2014 Inspection of Kabani & Company, Inc.

Dear Ms. Munter:

We appreciate the opportunity to read and comment on Part I of the PCAOB's Draft Report on the 2011 Inspection of Kabani & Company, Inc. dated January 26, 2015 ("Draft Report").

We conducted a thorough evaluation of the matters identified in the Draft Report and addressed the engagement-specific findings in a manner consistent with PCAOB auditing standards and Kabani & Company, Inc. policies and procedures.

Very truly yours,

Kabani & Company, Inc.

Hamid kabani
Hamid Kabani, CPA
President

Issuer A:

The failure to perform sufficient procedures to evaluate the issuer's recognition of certain income

Response:

First, it has to be noted that this issuer was not originally in the list of issuer selected by the PCAOB inspection team when they began the inspection process on May 19, 2014. This issuer was added subsequent to May 19, 2014. Secondly, the firm issued the report on the issuer's financial statements on **April 15, 2015**. In accordance with the PCAOB rules (AS-3), the firm was required to complete the documentation and assembly of the audit working file within 45 days of the issuance of the report, which was **May 30, 2014**. The filed inspection took place from **May 19, 2004 through May 23, 2014** when this comment was brought up by the PCAOB inspection team, **well ahead of the file completion date.** The PCAOB inspection team was communicated upon via email dated May 23, 2014 that since the file completion date has not yet occurred; the firm was still in process of wrapping up the documentation in the file, specifically "*the file completion documentation*". Therefore, this comment was issued unjust and based upon wrong assumptions without review of all the documentations upon completion of the file including the file completion documentations.

And finally, the overall impact of this comment on the financial statements of the issuer was immaterial as discussed below and per the Appendix 1 (please refer to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit). The total impact of this entire comment was US $40,657 as compared to the financial materiality of US $410,000. The quantitative as well as qualitative analysis performed per Appendix 1 clearly shows that the impact of the understatement of revenue (if any) on the financial statements was immaterial and the audit procedures performed to be adequate and sufficient.

Originally, when the Issuer established the rental income recognition per US GAAP and FASB standard, revenue recognition in straight-line basis was adopted as there was no sufficient historical data to support other systematic basis. This is consistent with the paragraphs 1–2 of FASB ASC 840-20-25 which state that the lessor should recognize rent revenue on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.

In the Issuer's operations, the increase of rent (i.e. escalation clause) is applied only to those contracts with long lease term due to the necessity of adjustment of rent over time. The consideration of increase portion includes the customer's original rent level, the customer's business conditions, the general level of Shenyang rental market, the inflation rate in China and the overall performance of economy. Per the contracts the Firm examined, the increase of 5% up to 15% kicks off during middle (e.g. third year out of 4 year lease term) or later phrase of the contracts (for 5 year lease terms, it usually starts in the fourth year). This appears reasonable considering the gradual increase of rent of commercial buildings in Shenyang region, as well as overall China market, as well as an average of 3.57% of inflation rate each year in China during 2011 to 2013.

Over a period of time, the issuer gradually found out that rental income on straight-line basis for those rental contracts with escalation clause may not be appropriate based on the historical data and Issuer's evaluation due to the probable early termination of contracts by the customers (tenants). Therefore, in order to present more fairly stated revenue, the Issuer recognized the revenue based on the amount per the contract term instead of the straight-line basis over the lump sum of the whole contract.

Per the issuer's accounting policy, the current accounting treatment, rather than straight-line basis, is a more accurate and representative of the time pattern in which the leased property is physically employed due to the fact that there have been **numerous early terminations of lease contracts** in the recent times. Otherwise, this could lead to potential overstatement of the rental income.

During the audit of the issuer, the firm noted that the early terminations of the contracts do frequently occur. The Firm also noted that, due to the current economic slowdown in China, similar early termination is getting more and more common in real estate market. Such occurrence of early termination would lead to overstatement of revenue if the incremental rental income is recognized on straight line basis, due to the particular nature of the economic environment in which the issuer operates. Per SAB 104, "The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met: ....***Collectability is reasonably assured**." Considering the slowing down of the Chinese economy, the difficult phase through which the Chinese Real Estate rental market is currently going through and based upon the historical pattern of the issuer's operations, the collectability could not be assured for such leases over the entire duration of the lease term. Recording of the lease increment which has not occurred and is not reasonably assured, could lead to certain overstatement of the revenue.

Also, the lease agreements contain a clause whereby the lease could be cancelled at the option of either the lessor or the lessee, by paying a small penalty equal to two month's rent which is roughly 3.5% of the total lease term (please see below for more discussion on the issue). Hence, the Issuer recognized the rental income with the amount of the related period per lease contract, in order to have more accurate revenue recognition. Per the Issuer's determination, the current accounting treatment, rather than straight line basis, is a more accurate and representative of the time pattern in which the leased property is physically employed due to the fact that there have been early terminations of lease contracts in the past.

Per ASC 840-20-20, a lease is considered to be cancellable under **any** of the following conditions:

a) Upon the occurrence of some remote contingency
b) With the intention of the lessor
c) If the lessee enters into a new lease with the same lessor
d) If the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured.

Per the lease agreement, the lease could be cancelled at the option of lessor, with a payment of a small penalty. Lessor will only charge two month of rent as penalty, considering the applicable long lease term (which lasts from 4 or 5 years up to 10 years), the penalty is deemed immaterial (apx 3.3 % of total lease payments).

In addition, the majority of the lease contracts are for one to three year lease terms. The contracts with long lease term (i.e. 5 years and above) are only 13 in total, let alone the fact that only 8 of them have escalation clause.

For the lease contracts which are offering one month for free, they also represent a minority of the entire population, which could cause immaterial misstatement of the revenue. The free rentals are available to those leases which are not cancelled.

The Firm performed a qualitative and quantitative analysis of the escalation clause and the impact of free rental provisions in the issuer's agreements, and the related potential misstatement of rental income for the year under audit (please refer to Appendix I - Misstatement analysis on lease accounting on rental income recognition). The Firm's analysis includes an extrapolation of potential errors resulting from rent escalation and free rent provisions identified by the inspection team in the contracts reviewed, and additional contracts selected and identified by the Firm.

The Firm's analysis was based on its inquiries of the management of the issuer regarding the number of contracts with rent escalation and free rent clauses, review of the historical trend of the issuer's rent recovery and review of the agreements selected on sample basis. The Firm's analysis also included an assertion that the Issuer's current accounting treatment, rather than a straight line basis, was more rational and representative of the time pattern over which the leased properties were physically employed by the issuer due to the issuer's history of early terminations of lease contracts.

The Firm designed its audit procedures for testing the Issuer's revenue and obtained audit evidences by following guidelines per PCAOB Auditing Standard No. 15. Based on the sampling worksheet with all control risk set to maximum, the Firm selected the sample population by examining those revenue transactions with supporting documents including related contracts, invoices, payment documents from the customers and receipts. The amount of the revenue substantive testing covered 44% of total revenue recognized during the fiscal year of 2014. The Firm also performed sales cut-off testing to ensure the reasonableness of cut off. Furthermore, the Firm obtained rental contracts of 55 (fifty five) customers and verified the amount with the agreements, and verified the advances received by the issuer to ensure the existence of the customers and valuation of the revenue. The Firm performed similar procedures for the audit of the Property management income, another major revenue stream of the Issuer.

Based on the consideration mentioned above, the Firm determined that it has performed sufficient procedures to test the occurrence, completeness, and valuation of rental income in accordance with PCAOB Audit Standard, identified the necessity of provisions in the issuer's rental contracts related to rent escalation and free rent periods, and evaluated the significance of variance between Issuer's accounting for rental income and disclosed accounting policy in its financial statements in which **the impact was immaterial.** In addition, the Firm deemed that that the Issuer's current accounting on rental income recognition is more representative and rational than accounting for rental income on a straight line basis which is consistent with the FABS standard of ASC 840-20-25 which state that the lessor should recognize rent revenue on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.

Issuer B:

The failure to perform sufficient procedures to evaluate the appropriateness of the capitalization of certain costs Redacted. Confidential Treatment Request Granted by the Board Pursuant to PCAOB Rule 4007(b)

Response:

It has to be noted that this comment was never discussed or brought up during the field inspection period through May 23, 2014. However, this comment was brought up via an email and subsequent discussion on June 17, 2014, almost a month subsequent to the inspection, to make up the two comments created for the firm. Also to be noted is that this comment relates to a product developed in **2008 (the issuer had not developed any new product since 2008)** and the technical feasibility report for the product was obtained in **2008 and is included in the 2008 work paper files.** The Exhibits mentioned in the following section are incorporated herein by reference to previously submitted Exhibits on July 17, 2014:

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

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

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

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

b. Software under development

(1) *The Firm's documentation contained an evaluation of the risks associated with the development of the projects and discussed the issuer's plan for addressing such risks, and provide information that the risks had been resolved through coding and testing;*

The Firm would like to refer to ASC 985-20-25-2 which states that 'For purposes of this Subtopic, the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements. At a minimum, the entity shall have performed the activities in either (a) or (b) as evidence that technological feasibility has been established:

a. If the process of creating the computer software product includes a detail program design, all of the following:

   1. The product design and the detail program design have been completed, and the entity has established that the necessary skills, hardware, and software technology are available to the entity to produce the product.
   2. The completeness of the detail program design and its consistency with the product design has been confirmed by documenting and tracing the detail program design to product specifications.
   3. The detail program design have been reviewed for high risk development issues (for example, novel, unique, unproven functions and features or technological innovations), and any uncertainties related to identified high risk development issues have been resolved through coding and testing.

b. If the process of creating the computer software product does not include a detail program design with the feature identified in (a), both of the following :

   1. A product design and a working model of the software product have been completed.
   2. The completeness of the working model and its consistency with the product design has been confirmed by testing.'

Regarding the Technological Feasibility Reports (Exhibit 3a & Exhibit 3b) obtained by the Firm during the June 30, 2008 audit (there is no additional new product since 2008), please note that these feasibility reports per the exhibits 3a & 3b, were the 'final version' and the actual development designs/ solution architecture which was prepared subsequent to determining and resolving any uncertainties related to the identified development issues through coding and testing. The audit team documented in the work paper files (provided to the PCAOB inspection team), as per follows, describing the process followed at the issuer before the development of any product is commenced or 'Product development life cycle':

- First, an idea is conceived for new a product and if it seems attractive, the management forms a committee to further test the idea for financial and technological feasibility.
- The Committee prepares a draft functionalities and risk assessment of the product.
- Based on this initial draft of functionalities, the IT requirements are established. The IT requirements include the requirements relevant to software, hardware as well as the environment.
- The Network Operations team makes sure that a working environment is available.
- The committee identifies test cases to be developed to mock the actual functionalities to verify that the product can be developed.
- If the mock tests are cleared, it is established that technologically the idea is workable.
- The final decision of this committee is in the form of minutes of meeting. The final version of Project Feasibility along with the minutes is presented to senior management for final approval.

As clearly evidenced from the work paper file, the Firm had obtained the final version of the feasibility report (Exhibit 3a & Exhibit 3b), which was prepared after the mock test was successful. Hence, all the uncertainties related to the identified development issues were tested during the coding and testing of these mock test cases. Please find attached herewith the minutes of the meeting of the Committee established for the Feasibility Study of FMS & Blue Star projects (Exhibit 4a & Exhibit 4b).

The Minutes reviewed by the firm and included in the work paper files clearly state that the high risk development issues areas have already been considered & either mitigated or planned to be mitigated and there are no such issues which could create hurdles or bottlenecks in the development of the product. Also, another fact that needed to be considered was that the Issuer had been providing this solution since 1998, and it had comprehensive domain knowledge, hands on experience, IT and human resources for developing its next version, thus, there were lower risks of development of the newer version of the **same product**. During each subsequent year's audits, the firm made sure that Core functionalities and structures are totally on the original design, platform, architecture and structure and no material changes have occurred. Hence, the Firm believes that as required by ASC 985-20-25-2, it had reviewed the Feasibility Reports, the Risk Assessment documents and the Minutes of the Committee established for Feasibility Study to ascertain that the Issuer had carried out all activities that are necessary to establish that the product can be produced to meet its design specifications and that all high risk development issues have been taken care of before the commencement of development of the software product.

(2) *The Firm's documentation discussed the issuer's decision to design the projects, and indicated whether technological feasibility had been reached, including whether the issuer had completed all planning, designing, coding and testing related to the projects.*

As discussed above (1), the technological feasibility reports obtained for FMS and Blue Star (Exhibit 3a & Exhibit 3b) were the final versions which were approved by the senior management of the Issuer on following all the steps of the 'Product Development Life Cycle' as described above. The approval of the management was documented via minutes of the meeting of the Committee established for the Feasibility Study of FMS & Blue Star projects (Exhibit 4a & Exhibit 4b). **The Minutes clearly state that the high risk related to the development has already been considered and these risks are mitigated or planned to be mitigated.**

During the audit for the year ended June 30, 2008, the audit engagement team had obtained and tested the Feasibility Reports (Exhibit 3a & Exhibit 3b) and as per the requirements of ASC 985-20-25-2, the audit team verified that the Issuer had:

- Completed product design (refer to the detail designs of FMS and solution architecture of Blue Star),
- Established that the necessary skills, hardware and software technology are available
- Performed Risk Assessment for any development issues
- In addition, the issuer had also prepared mocks / pilots of the product and developed test cases for testing the result.

Thus, these Feasibility Reports, the minutes and the audit documentations do indicate that the planning, designing, coding and testing related to these projects had been completed without any ambiguity thus, confirming that the technological feasibility for these products had been established.

(3) *The Firm's documentation included, for one of the projects, a project plan for the proposed application design, data model design, architectural evaluation and software design of the product, indicating that the issuer has completed its design for the product.*

Please refer to the technological feasibility report of Blue Star (Solution Architecture) (Exhibit 3a). Please note that the project plan is actually referring the development activities related to detail design, data model and system modules development. These development activities are carried-out based on initial system architecture, comparative technology studies and mock testing.

The Software Architecture and the Design documents for different components are evidence of design completion. As a result, the Blue Star detail design and product specification is part of the Feasibility Report **which indicates that the design for the product was completed**.

Based on the responses in the earlier paragraphs, the Firm believes that it has performed more than sufficient procedures to evaluate that the issuer's capitalization of costs for these two products in accordance with ASC 985-20 and that the Firm has more than sufficient evidence in the audit documentation to support the premise that the technological feasibility was achieved during the fiscal year 2008.

APPENDIX 1 (ISSUER - 1):

Misstatement analysis on lease accounting on rental income recognition

We noted that for certain lease contracts of lessees of presidential building with the long lease term (those with 4, 5 years or above), there is a rental escalation clause included in the lease term

In addition, we also noticed that for certain lease contracts with multiple-years lease term, the Issuer offers free first month for renovation, or free month each year during the lease term after the completion of the first year lease.

Quantitative analysis:

In our quantitative analysis, based on a SAMPLE of the 20 soft copies of contracts we placed in the work paper folders, there are 3 contracts with escalation terms (2013-MD_SA-4, SA-5 and SA-9). And all of these 3 contracts have either 4 or 5 year lease terms, whereas there is a 5 year lease term contract (2013-MD_SA-3) without any escalation clause. This shows that escalation clause is not necessarily included in those contracts with long lease term. This is consistent with our discussion with the management, review of various contracts during the current audit and past audits.

Per extrapolation with total population of 200 tenants in presidential building, there is an expectation of 30 tenants with escalation clause. Per the three contracts in our audit sample, which included the escalation clause, the increase in the second phrase varies from (RMB 26,000 to 58,000, or approximately 5% to 15% in terms of increase rate), which started either the third (out of 4 year lease term) or fourth year of the contract (out of 5 year lease term). This shows that the escalation clause with increased rent kicked off in the middle of later phrase of the lease term. Based on the contracts we noted, the period with increased rate was 2.5 years over 5 year lease term, and increase amount of RMB 50,000. The total understatement per the extrapolation equals to RMB 750,000 (2.5 years x RMB 50,000 / 5 year lease term x 30 extrapolated samples). Per further analysis of the issuer's contracts, we found that there are 13 contracts with 5 years or above, and only 8 of those have escalation clause. This shows our extrapolation covers the highest end of misstatement and no further sensitivity analysis is necessary.

Also, we noted that for certain multiple year lease contracts, there are offers of either first month of lease contract for free (for renovation purpose) or one month for free in each year of lease term after completion of first year lease. Based on the 20 soft copies of contracts we placed in the work paper folders, there are 2 contracts offering first month for free for renovation purpose (for the period in 2011 and 2012 in 2013-MD_SA-7 and SA-18 respectively), which have no impact for current year. In addition, there are two contracts (2013-MD_SA-2 and SA-10) which offers one month for free rent during 2013. The extrapolated population is 20 samples. The related monthly rent varies from RMB 17,000 to 26,000. Considering the average monthly rent of all presidential building tenants being RMB 12,510, we estimated the amount being overstated per extrapolated sample as RMB 25,000. The total understatement per the extrapolation equals to RMB 500,000.

Per inquiry with the management of the issuer (supported by the evidences and documented in the work paper file), there are total 22 customers being offered with such incentive terms. In this case, we double the extrapolated overstatement as sensitivity analysis to come up with RMB 1,000,000 overstatement.

Per our audit planning documentations, **the audit planning materiality is calculated at $410,000**, the tolerable misstatement is USD 300,000 (or RMB 1,844,907 per average rate of 6.149 for year 2013). Either overstatement of RMB 1,000,000 or understatement of RMB 750,000 is over the tolerable misstatement. The net effect of RMB 250,000 is even less than our threshold of Individually Significant Amounts of USD 100,000 (or RMB 614,900). Hence, in terms of quantitative analysis, the misstatement is immaterial.

Samples noted with escalation clause	3
Samples in workpaper folder under EM	20
Total population of presidential bldg	200
Extrapolated samples	**30**
Average period under escalation clause (yr) out of 5 yrs	**2.5**
Average amount of escalated (increase)amount	**RMB 50,000**
Extrapolated amount (understatement of rental income)	**RMB 750,000**
or, in USD at average rate of 6.149 during 2013	**USD 121,971**
Samples noted with one month for free offer	2
Samples in workpaper folder under EM	20
Total population of presidential bldg	200
Extrapolated samples	**20**
Average amount of monthly rent for lease with one month free offer	**RMB 25,000**
Extrapolated amount (overstatement of rental income)	**RMB 500,000**
or, in USD at average rate of 6.149 during 2013	**USD 81,314**
Sensitivity analysis (200%)	**RMB 1,000,000**
or, in USD at average rate of 6.149 during 2013	**USD 162,628**
Net effect in rental income (overstatement)	**RMB 250,000**
or, in USD at average rate of 6.149 during 2013	**USD 40,657**
	less than ISI

Qualitative analysis:

We also performed the qualitative analysis for the misstatement of lease accounting.

Paragraphs 1–2 of FASB ASC 840-20-25 states that the lessor should recognize the rent revenue on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.

Per the issuer's lease policy (please refer to Exhibit 1. Explanation of escalation clause in lease contract by GCIH), the increase of rent (i.e. escalation clause) is applied to those contracts with long lease term due to the necessity of adjustment of rent over time. The consideration of increase portion includes the customer's original rent level, the customer's business conditions, the general level of Shenyang rental market, the inflation rate in China and the overall performance of economy. Per the contracts we examined, the increase of 5% up to 15% kicks off during middle (e.g. third year out of 4 year lease term) or later phrase of the contracts (for 5 year lease terms, it usually starts in the fourth year). This appears reasonable considering the gradual increase of rent of commercial buildings in Shenyang region, as well as overall China market, as well as an average of 3.57% of inflation rate each year in China during 2011 to 2013.

The fact that the issuer did not recognize the incremental rental income on straight line basis over the overall lease contract is due to the **early termination clause** in the contracts. Based upon the issuer's history and the evaluation, the early termination of contracts do occur on more than frequent basis. Also, due to the current economic slowdown in China, similar early termination is getting more and more common in the real estate rental market. Such occurrence of early termination would lead to an overstatement of revenue if rental income is recognized on straight line basis. Per SAB 104, "The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met: ....***Collectability is reasonably assured**." Considering the decline of Chinese economy and the difficult phase through which Chinese Real Estate rental market is currently going through **including decline in rental rates and vast availability of the rental space,** collectability could not be assured for such lease over the entire duration of the lease term specifically considering the frequency of cancellation of the lease agreements. Recording of the lease increment which has not occurred and is not reasonably assured, could lead to overstatement of revenue in this economic environment. More importantly, the lease agreements contain the clause whereby the lease could be cancelled at the option of either the lessor or the lessee, by paying a small penalty equal to two month's rent which is roughly 3.5% of the total lease term (please see below for more discussion on the issue). Hence, the issuer recognized the rental income with the amount of the related period per lease contract, in order to have more accurate revenue recognition. Per the issuer's consideration, the current accounting treatment, rather than straight line basis, is a more accurate and representative of the time pattern in which the leased property is physically employed specifically considering the circumstances surrounding the Chinese market and history of such pattern.

Per ASC 840-20-20, a lease is considered to be cancelable under **any** of the following conditions:

a) Upon the occurrence of some remote contingency
b) With the intention of the lessor
c) If the lessee enters into a new lease with the same lessor
d) If the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured.

Per the lease agreement, the lease could be cancelled at the option of lessor, with a payment of a small penalty. Lessor will only charge two month of rent as penalty, considering the applicable long lease term (which lasts from 4 or 5 years up to 10 years), the penalty is deemed immaterial (apx 3.3 % of total lease payments).

In addition, the majority of the lease contracts are for one to three year lease terms. The contracts with long lease term (i.e. 5 years and above) are only 13 in total, let alone the fact that only 8 of them have escalation clause.

For the lease contracts which offering one month for free, they also represent a minority population with immaterial misstatement of revenue recognition. These free rentals are available to the leases which are not cancelled.

Conclusion:

Based upon the audit and the quantitative and qualitative analysis, the firm believes the recording of lease rental is appropriate and there is not a material misstatement that has any significant impact on the financial statements of Great China international Holdings, Inc. As described above, the recording of revenue (as suggested by the PCAOB staff) without reasonable assurance of collectability would be against the spirit of the SEC rules and regulations (SAB 104) and therefore, would lead to the misstated financial statements.

APPENDIX A

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. 14, *Evaluating Audit Results*		
EVALUATING THE RESULTS OF THE AUDIT OF FINANCIAL STATEMENTS		
Evaluating the Presentation of the Financial Statements, Including the Disclosures		
AS No. 14.30	The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Note: AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles,* establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements. Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.	Issuers A and B
AS No. 14.31	As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential	Issuer A

	for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18]	
Footnote to AS No. 14.31 [18] AU secs. 508.41-.44.		