



ABC, INC.

**A Comprehensive Decision Based Case,
3rd Edition, 2015**

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Section 1

FINANCIAL STATEMENTS AND NOTES

ABC INC



SIC Code 7372 - Prepackaged Software
Industry Software & Programming
Sector Technology
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BUSINESS

Our Company

We provide on-demand software solutions and services for the residential mortgage industry in the United States . Our mortgage management solutions help streamline and automate the process of originating and funding new mortgage loans, thereby increasing efficiency, improving loan quality, facilitating regulatory compliance and reducing documentation errors while providing one system of record for loans .

Our Awesome software is an end-to-end, comprehensive enterprise solution that handles most of the functions involved in running the business of originating mortgages: customer relationship management; loan processing; underwriting; preparation of application, disclosure and closing documents; funding and closing the loan for the borrower; compliance with regulatory and investor requirements and overall enterprise management that provides one system of record. Delivery of our Awesome software in an on-demand Software-as-a-Service, or SaaS, environment provides customers with the added benefits of lower up front implementation costs and reduced need for an infrastructure of servers, storage and network devices as well as providing access to the most current release of an application, periodic upgrades and regulatory updates. We also host the ABC Network , a proprietary electronic platform that allows Awesome users to conduct electronic business transactions with investors and settlement service providers they work with in order to process and fund loans. As of December 31, 2013 , the ABC Network electronically connects the approximately 92,000 mortgage professionals using Awesome to the broad array of mortgage lenders, investors and third-party service providers integral to the origination and funding of residential mortgages.

For mortgage originators, Awesome is a comprehensive operating system that handles key business and management functions involved in running a mortgage origination business. Mortgage originators use Awesome as a single tool for loan processing, marketing, customer communication and to interact electronically with lenders, investors and service providers over the ABC Network. We also offer Awesome users a variety of other on-demand software services, including : Awesome Docs Solution , which automatically prepares the disclosure and closing documents necessary to fund a mortgage ; Awesome CenterWise , a bundled offering of electronic document management, or EDM , and websites used for customer relationship management; Total Quality Loan, or TQL , which offers a suite of fraud detection, valuation, validation and risk analysis services ; Awesome Compliance Service , which automatically checks for compliance with federal, state and local regulations throughout the origination process ; tax transcript services which provide income verification capability; services for ordering and managing appraisals; Awesome CRM , a suite of tools for managing contacts, leads and marketing campaigns; Awesome Product and Pricing Service , which allows Awesome users to compare loans offered by different lenders and investors to determine appropriate mortgage programs available to a particular borrower ; and Awesome Flood Service , which allows Awesome users to order and transfer flood zone certifications.

For the lenders, investors and service providers on the ABC Network, we provide electronic connectivity that allows them to do business with a significant percentage of the mortgage origination professionals in the United States.

Mortgage originators purchase Awesome software as a service, paying either recurring subscription fees or monthly fees based on the number of licensed users and mortgages funded. Our additional services are paid on a subscription or transaction basis. Lenders and service providers participating in the ABC Network also pay us fees, generally on a per transaction basis, for business received from Awesome users.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our financial condition and results of operations in conjunction with the financial statements and the notes thereto included elsewhere in this Annual Report on Form 10-K. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Annual Report on Form 10-K, particularly in "Risk Factors" and "Special Note Regarding Forward-Looking Statements."

Overview

We provide on-demand software solutions and services for the residential mortgage industry in the United States. Our mortgage management solutions help streamline and automate the process of originating and funding new mortgage loans, thereby increasing efficiency, improving loan quality, facilitating regulatory compliance and reducing documentation errors while providing one system of record for loans .

Mortgage originators use our Awesome software, a comprehensive operating system that handles key business and management functions involved in running a mortgage origination business. Mortgage originators use Awesome as a single tool for loan processing, marketing, customer communication and to interact electronically with lenders, investors and service providers over the ABC Network. Our software also

enables enforcement of rules and business practices designed to ensure loan quality, adherence to processing standards and regulatory compliance.

We also offer Awesome users a variety of other on-demand software services, including : Awesome Docs Solution, which automatically prepares the disclosure and closing documents necessary to fund a mortgage ; Awesome CenterWise, a bundled offering of EDM and websites used for customer relationship management; TQL , which offers a suite of fraud detection, valuation, validation and risk analysis services using streamlined workflows and processing rules; Awesome Compliance Service, which automatically checks for compliance with federal, state and local regulations throughout the origination process ; tax transcript services which provide income verification capability to our customers; Awesome Product and Pricing Service, which allows Awesome users to compare loans offered by different lenders and investors to determine appropriate mortgage programs available to a particular borrower and Awesome Flood Service, which allows Awesome users to order and transfer flood zone certifications. By the nature of our on-demand service, even with our robust security monitoring and detection systems, we cannot guarantee that our security measures will prevent security breaches and we may need to expend significant resources to protect against and remedy any potential security breaches and their consequences.

The ABC Network electronically connects the approximately 92,000 mortgage professionals using Awesome to the broad array of mortgage lenders, investors and third-party service providers integral to the origination and funding of residential mortgages. During the mortgage origination process, mortgage originators may order various services through the ABC Network , including credit reports, product eligibility and pricing services, automated underwriting services, appraisals, title reports, insurance, flood certifications and flood insurance, compliance reviews, fraud detection, document preparation and verification of income, identity and employment. Mortgage originators can also initiate secure data transmission to and from lenders and investors.

We were formed as a California corporation in 1997 and reincorporated in Delaware in November 2009. From inception through 2000, we developed consumer-facing websites and initial versions of our network. We launched our first transaction platform in late 2000, the present version of which is the ABC Network .

Our revenues consist of on-demand and on-premise revenues. On-demand revenues are generated primarily from software subscriptions we host that customers access through the Internet, including customers who pay fees based on the number of loans they fund, or success basis, subject to monthly base fees, which we refer to as Success-Based Pricing. On-demand revenues also include software services that are sold transactionally as well as ABC Network transaction fees paid by lender-investors, service providers and certain government-sponsored entities participating on the ABC Network . On-premise revenues are generated from customer-hosted software licenses and implementations, training and maintenance services. For further discussion of the sources of our revenue and our revenue recognition policy, please see our Critical Accounting Policies and Estimates below.

Our on-demand revenues generally track the seasonality of the residential mortgage industry, typically, but not always, with increased activity in the second and third quarters and reduced activity in the first and fourth quarters as home buyers tend to purchase their homes during the spring and summer in order to move to a new home before the start of the school year. Mortgage volumes are also impacted by other factors such as interest rate fluctuations, home sale activity and general economic conditions, which can lead to departures from the typical seasonal pattern. For example, increases in mortgage interest rates could reduce the volume of new mortgages originated and, in particular, the volume of mortgage refinancings. We currently estimate that approximately 30% to 40% of our revenues has some sensitivity to volume. Contracted revenues, which are not sensitive to volume, represented 57% of total revenues for the year ended December 31, 2013.

We are investing aggressively in initiatives that we believe will help us continue to grow our business, improve our products and services and strengthen our competitive advantage while bringing sustainable, long-term value to our customers. During 2013, we accelerated our investments in our sales and client services capabilities, in research and development and in technology infrastructure to support our user additions and overall business growth. These investments included expanding our talent across the organization by hiring additional personnel, especially for our customer acquisition, client services and implementation teams and our research and development teams; developing next-generation products and enhancements; purchasing computer equipment; upgrading our telephony systems and building out new office facilities.

In addition to our internal initiatives, our business strategy has evolved to address recent industry trends, including:

- expected lower lending volume;
- increased quality standards imposed by regulators, lenders and investors;
- increased regulation affecting lenders and investors;
- greater focus by our customers on operational efficiencies; and
- customers adopting multi-channel strategies

We are responding to these trends as follows:

Expected lower lending volume. Mortgage lending volume is expected to be lower in 2014 than in 2013 , as forecasted by Fannie Mae, Freddie Mac and the Mortgage Bankers Association. Since late 2009, we have focused our marketing and sales efforts on our on-demand SaaS Awesome offering, and particularly our SaaS Awesome Success-Based Pricing model, in contrast to our on-premise license model. In our on-

demand SaaS Awesome offering, the customer does not pay the significant up-front licensing fee associated with our license model, which we believe is particularly attractive in the present climate of the residential mortgage origination market. Our SaaS Awesome Success-Based Pricing model builds on this value proposition by aligning customers' payments for our software solutions with their own receipts of revenues. Our focus on our SaaS Awesome offering is important in light of lower lending volumes because we typically generate greater revenues per user through our on-demand SaaS Awesome offering than through our on-premise license offering.

We are also focusing on increasing use of our ABC Network offerings and our other services, which were introduced from late 2009 through late 2011. These offerings include our TQL program, Awesome Compliance Service, Awesome Product and Pricing Service, Awesome Docs Solution and Awesome 4506-T Service. During 2013 and 2012, Awesome users employed the ABC Network to process on average approximately six and five transactions per loan file, respectively. By continuing to enhance our service offerings and encouraging providers of settlement services to deliver their services electronically through the ABC Network, we will continue to build value for ABC Network participants while increasing the number of transactions for which the ABC Network is used.

Increased quality standards imposed by regulators, lenders and investors. Awesome is designed to automate and streamline the process of originating mortgages to, among other things, satisfy increased quality requirements of investors. Relevant features of Awesome include enabling customers' management to impose processing rules and formats, and providing milestone and process reminders, automated population of forms with accurate data, and accurate and automated transmission of loan files and data from originators to investors and lenders. Our TQL program is designed to further enhance the quality, compliance and saleability of loans that are originated through Awesome. Additionally, TQL is intended to reduce the opportunities for errors in the process of transferring information from originator to investor and give investors confidence in the accuracy and regulatory compliance of the information that is underlying loan files.

In response to the increased quality standards and compliance mandates affecting the industry, we expect an increased number of mortgage lenders to assess new platform options and replace their legacy systems. We have increased the size of our customer acquisition, implementation and support teams by approximately 42% from December 31, 2012 to December 31, 2013 in order to address anticipated demand for our software solutions.

Increased regulation affecting lenders and investors. Regulatory reforms have significantly increased the complexity and importance of regulatory compliance. We devote considerable resources to continually upgrading software to help customers address regulatory changes. We offer Awesome Compliance Service, which automatically checks loan files for compliance with the myriad of federal, state and local regulations and alerts users to possible violations of these regulations. In addition, we have a staff of attorneys and work with compliance experts who help assure that documents prepared using our software and the processes recommended by the Awesome workflow comply with applicable rules and regulations. We believe we are well-positioned to help our customers meet additional requirements from the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank Act, that became effective in January 2014. Our ATR / QM functionality is designed to allow our customers to document their compliance with the CFPB's ATR / QM Final Rule that applies to the majority of residential mortgage loan originations in the United States. We believe we are also well-positioned to help our customers meet future Dodd-Frank Act requirements as they are published and become effective.

Greater focus on operational efficiencies. Mortgage originators experienced an approximately 40% increase in direct production costs per loan between 2009 and 2011¹, and we expect this trend to continue due to continued increased regulation and heightened quality standards. By automating many of the functions of mortgage origination, we enable our users to comply with regulations and process quality loans more efficiently and effectively. This reduces the cost of originating a loan and lowers the risk of buy back demands from investors resulting from poorly originated or documented loans and/or loans that fail to comply with applicable regulations.

With an eye towards providing customers with ever-greater tools to enhance efficiency, we will continue to develop new service offerings through the ABC Network and pursue adoption of our services through initiatives such as our TQL program. By integrating and expanding our current and new services, we will provide a more comprehensive benefit to our users.

In addition to providing efficiency-enhancing solutions, delivery of our Awesome software in an on-demand SaaS environment provides customers with the added benefits of lower up front implementation costs and reduced need for an infrastructure of servers, storage and network devices as well as providing access to the most current release of an application, periodic upgrades and regulatory updates.

Customers adopting multi-channel strategies. Customers are developing multi-channel strategies beyond a single retail, correspondent or wholesale channel in order to grow their businesses. The requirements of these different channels vary and in order to maintain a single operating system, customers must use a robust system with customizable functionality. We continually address the changing needs of our customers by developing and enhancing tools to allow for simplified regulatory compliance, increased availability of information, and enhanced system functionality and performance.

Acquisition Strategy

Our industry is highly fragmented, and we believe there are strategic opportunities available to acquire competing software companies or software providers that offer related mortgage origination functionality that will complement and increase the attractiveness of Awesome. For example, in January 2014, we acquired substantially all the assets of MortgageCEO,

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The following table shows these operating metrics as of and for the years ended December 31, 2013, 2012 and 2011:

	Year ended December 31,		
	2013	2012	2011
Revenues (in thousands):			
Total revenues	\$ 128,481	\$ 101,845	\$ 55,494
Total contracted revenues	\$ 72,967	\$ 48,768	\$ 30,312
Total SaaS Awesome revenues	\$ 73,698	\$ 47,940	\$ 19,803
Users at end of period:			
Contracted SaaS users	95,044	60,187	35,745
Active Awesome users	92,161	73,687	53,767
Active SaaS Awesome users	63,695	41,458	24,252
Active SaaS Awesome users as a percentage of active Awesome users	69%	56%	45%
Active SaaS Awesome users as a percentage of contracted SaaS users	67%	69%	68%
Average users during period:			
Active Awesome users	87,276	63,993	51,455
Active SaaS Awesome users	55,421	33,203	19,330
Active SaaS Awesome users as a percentage of active Awesome users	64%	52%	38%
Revenue per average user during period:			
Revenue per average active Awesome user	\$ 1,472	\$ 1,592	\$ 1,078
SaaS Awesome revenue per average active SaaS Awesome user	\$ 1,330	\$ 1,444	\$ 1,024

Basis of Presentation

General

Our consolidated financial statements include the accounts of ABC, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated upon consolidation.

Revenue Recognition

We generate revenue primarily from transaction-based fees and fees for software and related services. Our software can be accessed either through a company-hosted subscription or a customer-hosted license. Accordingly, our revenues are now described as on-demand and on-premise revenues. Sales taxes assessed by governmental authorities are excluded from revenue.

On-demand Revenues

On-demand revenues are revenues generated from company-hosted software subscriptions that customers access through the Internet as well as revenues from a small number of customers that have opted to self-host a portion of the software but pay fees based on a per closed loan, or success, basis subject to monthly base fees, which we refer to as Success-Based Pricing. On-demand revenues are also comprised of software services sold transactionally and ABC Network transaction fees.

On-premise Revenues

On-premise revenues are revenues generated from maintenance services, sales of customer-hosted software licenses (except for customer-hosted Success-Based Pricing revenues, which are included in on-demand revenues described above), and professional services, which include consulting, implementation and training services.

Cost of Revenues and Operating Expenses

Cost of Revenues

Our cost of revenues consists primarily of: salaries and benefits, including stock-based compensation; expenses for document preparation, income verification and compliance services; customer support; data centers; depreciation on computer equipment used in supporting the ABC Network, SaaS Awesome and Awesome CenterWise offerings; amortization of acquired intangible assets such as developed technology and trade names; professional services associated with implementation of our software; and allocated facilities costs. We expect that our cost of

revenues will continue to increase in absolute dollars as our revenues increase, as we make additional investments in our technology infrastructure and as we continue to hire additional personnel in our implementation and customer support departments to support new customers.

Sales and Marketing

Our sales and marketing expenses consist primarily of: salaries, benefits and incentive compensation, including stock-based compensation and commissions; allocated facilities costs; expenses for trade shows, public relations and other promotional and marketing activities; expenses for travel and entertainment; and amortization of acquired intangible assets such as customer lists and contracts. We expect that our sales and marketing expense will continue to increase as we continue to hire additional sales personnel in order to address anticipated demand for our software solutions as we expect an increased number of mortgage lenders to assess new platform options and replace their legacy systems. We also intend to increase marketing activities focused on SaaS Awesome, our ABC Network offerings and our other Awesome services.

Research and Development

Our research and development expenses consist primarily of: salaries and benefits, including bonuses and stock-based compensation; fees to contractors engaged in the development and support of the ABC Network infrastructure, Awesome software and other products; and allocated facilities costs. We expect that our research and development expenses will continue to increase in absolute dollars as we continue to invest in our products and services and infrastructure, including hiring additional engineering and product development personnel.

General and Administrative

Our general and administrative expenses consist primarily of: salaries and benefits, including bonuses and stock-based compensation, for employees involved in finance, accounting, human resources, administrative and legal roles; consulting, legal, accounting and other professional services by third-party providers; and allocated facilities costs. We expect general and administrative expenses to continue to increase in absolute dollars primarily due to greater amounts of stock compensation expense relating to awards granted to attract and retain the employees needed to continue to grow our business.

Other Income (Expense), Net

Other income (expense), net consists of interest income earned on investments, cash accounts and notes receivable, offset by investment discount amortization and imputed interest expense related to the DMD acquisition holdback payments (see Note 5 of the Notes to Consolidated Financial Statements) and interest expense paid on equipment and software leases.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements which are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We evaluate our estimates and assumptions on an ongoing basis. Our estimates are based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Our actual results could differ from these estimates.

We believe that the assumptions and estimates associated with revenue recognition, income taxes, stock-based compensation, goodwill and intangible assets, fair value of investments, deferred commissions and software and website development costs have the greatest potential impact on our consolidated financial statements. Therefore, we consider these to be our critical accounting policies and estimates. For further information on all of our significant accounting policies, please see Note 2 of the Notes to Consolidated Financial Statements.

Revenue Recognition

We generate revenue primarily from on-demand and on-premise fees for software and related services.

On-Demand Revenues

Subscription Services and Usage-Based Fee Arrangements. Subscription services and usage-based fee arrangements generally include a combination of our products delivered as software-as-a-service, or SaaS, and support services. These arrangements are non-cancelable and do not contain refund-type provisions. These revenues generally include the following:

SaaS Awesome Revenues. We offer web-based, on-demand access to Awesome for a monthly recurring fee. We provide the right to access our loan origination software and handle the responsibility of managing the servers, providing security, backing up the data and applying updates; however, except where customers self-host a portion of the software in a Success-Based Pricing structure, customers under SaaS arrangements may not take possession of the software at any time during the term of the agreement. Subscription revenues are recognized ratably over the contract terms beginning on the commencement date of each contract, which is the date the Company's service

is made available to customers. Contracts generally range from one to five years . Alternatively, customers can elect to pay on a per closed loan, or success, basis. Success basis contracts generally have a term of one to five years and are subject to monthly base fees, which enable customers to close loans up to a contractually agreed-to minimum number of transactions, and additional closed loan fees, which are assessed for loans closed in excess of the minimum. Revenue is earned from both base fees and additional closed loan fees as the result of the customer's usage of Awesome. Monthly base fees are recognized over the respective monthly service period as the software is utilized. Additional closed loans fees are recognized when the loans are reported as closed. This offering also includes Awesome CenterWise, Awesome Compliance Service and Awesome Docs Solution for Awesome as integrated components, which are combined elements of the arrangement that is delivered in conjunction with the SaaS Awesome offering and therefore is not accounted for separately.

Awesome CenterWise Revenues. Awesome CenterWise is a bundled offering of EDM and websites used for customer relationship management. Generally, revenue is recognized for Awesome CenterWise after the service is rendered, except when Awesome CenterWise is automatically included as an integrated component of the SaaS Awesome offering, in which case the associated revenue is recognized as described above.

Services Revenues. We provide mortgage-related and other business services, including automated documentation preparation and compliance reports. Services revenues are recognized after the services are rendered.

Transaction Revenues. We have entered into agreements with various lenders, service providers and certain government agencies participating in the mortgage origination process that provide them access to, and ability to interoperate with, mortgage originators on the ABC Network. Under these agreements, we earn transaction fees when transactions are processed through the ABC Network. Transaction revenues are recognized when there is evidence that the qualifying transactions have occurred on the ABC Network and collection of the resulting receivable is reasonably assured.

On- Premise Revenues

With the exception of revenue from customers that self-host a portion of the software in a Success-Based Pricing structure , which is recognized as described above , revenue from the sale of software licenses is recognized in the month in which the required revenue recognition criteria are met, generally in the month in which the software is delivered. Revenue from the sale of maintenance services and professional services is recognized over the period in which the services are provided.

Income Taxes

We account for income taxes under the asset and liability method, which requires the recognition of taxes payable or refundable for the current year, and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that we believe is more likely than not to be realized.

Goodwill and Other Intangible Assets

Goodwill and other intangible assets are stated at cost less accumulated amortization, as appropriate. Other intangible assets include developed technology, trade names and customer lists and contracts. Intangibles with finite lives are amortized on a straight-line basis over the estimated periods of benefit, generally one to nine years. Goodwill is not amortized, but tested for impairment at least annually, or whenever changes in circumstances indicated that the carrying amount of goodwill or intangible assets may not be recoverable. These tests are performed at the reporting unit level, which is the company as a whole, using a two-step, fair-value approach. We completed annual impairment tests for the years ended December 31, 2013, 2012 and 2011 and determined that our goodwill was not impaired for those years.

If management's estimates of future operating results change, if there are changes in identified reporting units or if there are changes to other significant assumptions, the estimated carrying values of any such reporting units and the estimated fair value of goodwill could change significantly, and could result in an impairment charge. Such changes could also result in goodwill impairment charges in future periods, which could have a significant impact on our operating results and financial condition therein.

We assess the impairment of identifiable intangible assets whenever events or changes in circumstances indicate that an asset's carrying amount may not be recoverable. An impairment loss would be recognized when the sum of the undiscounted estimated future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. Such impairment loss would be measured as the difference between the carrying amount of the asset and its fair value. Cash flow assumptions are based on historical and forecasted revenue, operating costs and other relevant factors. If management's estimates of future operating results change, or if there are changes to other assumptions, the estimate of the fair value of our acquired product rights and other identifiable intangible assets could change significantly. Such change could result in impairment charges in future periods, which could have a significant impact on our operating results and financial condition.

Fair Value of Investments

All of our investments that have maturities of greater than 90 days are classified as available-for-sale and are carried at fair value. We invest excess cash primarily in investment-grade interest-bearing securities such as money market accounts, certificates of deposit, commercial paper, corporate bonds, municipal and government agency obligations and guaranteed obligations of the U.S. government all of which are subject to minimal credit and market risks. Fair value is determined based on quoted market rates when observable or utilizing data points that are observable, such as quoted prices, interest rates and yield curves. The cost of available-for-sale marketable securities sold is based on the specific identification method. Unrealized gains and losses, net of tax, are reported in stockholders' equity as accumulated other comprehensive loss. Realized gains and losses are included in other income (expense), net. Interest and dividends are included in other income (expense), net when they are earned.

As of December 31, 2013, our assets measured and recorded at fair value on a recurring basis included \$16.4 million of money market funds and \$105.5 million of marketable debt instruments. Of these marketable debt instruments, \$11.4 million was classified as Level 1 and \$94.1 million as Level 2. All of our money market funds are classified as Level 1. When determining fair value, we consider the principal or most advantageous market in which we would transact, and we consider assumptions that market participants would use when pricing the asset or liability. For further information, see "Fair Value of Financial Instruments" in Notes 2 and 4 of the Notes to Consolidated Financial Statements.

Credit risk is factored into the valuation of financial instruments that we measure and record at fair value. When fair value is determined using pricing models, such as a discounted cash flow model, the issuer's credit risk is factored into the calculation of the fair value, as appropriate.

Our money market funds and marketable debt instruments that are measured and recorded at fair value on a recurring basis and classified as Level 1 were classified as such due to the use of observable market prices for identical securities that are traded in active markets. Management judgment was required to determine the levels for the frequency of transactions that should be met for a market to be considered active. Our assessment of an active market for our marketable debt instruments generally takes into consideration the number of days each individual instrument trades over a specified period.

When we use observable market prices for identical securities that are traded in less active markets, we classify our marketable financial instruments as Level 2. When observable market prices for identical securities are not available, we price our marketable financial instruments using non-binding market consensus prices that are corroborated with observable market data; quoted market prices for similar instruments; or pricing models with all significant inputs derived from or corroborated with observable market data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs and, to a lesser degree, unobservable market inputs. We corroborate non-binding market consensus prices with observable market data as such data exists.

We had no investments classified as Level 3 at December 31, 2013.

Deferred Commissions

Deferred commission expenses are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to our direct sales force. Commissions are calculated based on a percentage of the revenues for the non-cancelable term of subscription contracts, which are typically one to five years.

Prior to 2013, commissions were paid and recognized as sales expense when customer payments for contracted services were received on a monthly basis because commissions were earned based on receipt of customer payments. In 2013, we amended our commission plans to provide for payment after the customer's contract is signed. As a result of the change in commission plans, beginning in 2013, commission expense is deferred and amortized to sales expense over the non-cancelable terms of the related subscription contracts. The deferred commission expense amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. The new plans also include claw back provisions, which require repayment of a proportionate amount of commissions, should customers cancel their contracts prior to the end of the initial contractual term.

Software and Website Development Costs

The Company capitalizes internal and external costs incurred to develop internal-use software and website applications. Capitalized internal costs include salaries, benefits and stock-based compensation charges for employees that are directly involved in developing the software or website application, and depreciation of assets used in the development process. Capitalized external costs include third-party consultants involved in the development process, as well as other direct costs incurred as part of the development process.

Capitalization of costs begins when the preliminary project stage is completed, and management authorizes and commits to funding a

project and it is probable that the project will be completed and the software or website application will be used to perform the function intended. Internal and external costs incurred as part of the preliminary project stage are expensed as incurred.

Capitalization ceases at the point at which the project is substantially complete and ready for its intended use, after all substantial testing is completed. Internal and external training costs and maintenance costs during the post-implementation operation stage are expensed as incurred.

Internal-use software is amortized on a straight-line basis over its estimated useful life, generally three years. Our management evaluates the useful lives of these assets on an annual basis and tests for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets. The capitalized costs are included in the property and equipment, net line in the accompanying consolidated balance sheets. For the years ended December 31, 2013 and 2012, we capitalized software and website application development costs of \$5.0 million and \$0.5 million, respectively. There were no such costs capitalized in the year ended December 31, 2011. There was \$69,000 in amortization of capitalized internal-use software and website development costs recorded during the year ended December 31, 2013 and no such amortization recorded during the years ended December 31, 2012 and 2011.

Total revenues increased \$26.6 million, or 26.2%, for the year ended December 31, 2013 as compared to the same period of 2012.

On-demand revenues increased by \$27.2 million, consisting primarily of a \$25.8 million increase in SaaS Awesome revenues, of which \$24.2 million related to our Success-Based Pricing model. SaaS Awesome revenues increased as a result of the addition of new SaaS Awesome users and as a result of upgrades of existing customers to our SaaS platform. The number of average active SaaS Awesome users increased by 66.9% from 33,203 for the year ended December 31, 2012 to 55,421 for the year ended December 31, 2013 due to the addition of new customers and the transition of on-premise licensed users to our SaaS Awesome Success-Based Pricing offering. The revenue growth attributable to the increase in average active SaaS Awesome users was partially offset by a 7.9% decrease in SaaS Awesome revenue per average active SaaS user from \$1,444 for the year ended December 31, 2012 to \$1,330 for year ended December 31, 2013, caused primarily by a decline in closed loan volume, lenders' focus on preparing for ATR / QM rules and longer implementation cycles for some of the larger customers that were added earlier in 2013.

Additional contributors to the growth in on-demand revenues were a \$1.0 million increase in revenues from our Awesome CenterWise offering primarily due to an increase in our customers, a \$2.5 million increase in revenues from our TQL program and a \$0.3 million increase in revenues from network transactions due to increased network usage for the year ended December 31, 2013 compared to the same period of 2012. Partially offsetting the increase in on-demand revenues was a \$2.9 million decrease in revenues from our standalone Awesome Docs Solution for the year ended December 31, 2013 compared to the same period of 2012, primarily as a result of the conversion of customers from standalone solutions to SaaS Awesome and partially from two standalone solutions subscription customers having gone out of business during the third quarter of 2013.

On-premise revenues decreased by \$0.6 million for the year ended December 31, 2013 compared to the same period of 2012, primarily due to a \$2.7 million decrease in software license and maintenance fees as our on-premise customers converted to SaaS Awesome Success-Based Pricing users. This decrease in revenues was offset by a \$2.2 million increase in revenues from implementation services for the year ended December 31, 2013 compared to the same period of 2012, as we began to charge for implementation services during the third quarter of 2013.

Total revenues increased \$46.4 million or 83.5%, for the year ended December 31, 2012 as compared to the same period of 2011.

On-demand revenues increased by \$41.9 million, consisting primarily of a \$27.7 million increase in SaaS Awesome revenue resulting from the addition of new SaaS Awesome users and upgrades of existing customers to our SaaS platform resulting from our continued marketing focus on our Success-Based Pricing model as well as an increase in mortgage origination volume. The number of active SaaS Awesome users increased by 70.9% to 41,458 users at December 31, 2012 from 24,252 users at December 31, 2011 due to the addition of new customers as well as the transition of on-premise licensed users to our SaaS Awesome Success-Based Pricing offering. SaaS Awesome Revenue per average active SaaS user increased by 41.0% for the year ended December 31, 2012 compared to same period of 2011 due to an increase in the number of closed loans per Active SaaS User as well as the continued movement of users to our Success-Based Pricing model, which offers higher revenue per user compared to our traditional license model.

On-demand revenues also increased due to continued adoption of new product offerings. Revenues from our tax transcript services that we began offering in the first quarter of 2011 increased by \$2.3 million while our appraisal and title services increased by \$1.2 million for the year ended December 31, 2012 compared to same period of 2011. Our TQL program was introduced during the fourth quarter of 2011 and TQL revenues increased by \$1.4 million for the year ended December 31, 2012 compared to the year ended December 31, 2011.

Other on-demand revenues increased due to a \$4.0 million increase in vendor transaction revenues due to increased network usage and a greater number of users, a \$2.1 million increase in compliance services due to increased usage by our customers as well as a greater number of users, a \$2.0 million increase in document preparation revenues and a \$1.2 million increase in other on-demand and transaction revenues.

On-premise revenues increased by \$4.5 million primarily due to DMD license and maintenance revenues. We acquired DMD in August 2011.

Gross profit increased by \$17.0 million and gross margin decreased by 2.8 percentage points during the year ended December 31, 2013 as compared to the same period of 2012 as revenues increased by \$26.6 million and cost of revenues increased by \$9.6 million. The decrease in the gross margin for 2013 is primarily a result of an increase in fixed costs associated with headcount added to our implementation, professional services and customer support organizations and investments we have made in expanding our data centers. Cost of revenues increased primarily due to a \$1.2 million increase in third-party royalty expenses to support the increased revenues, a \$5.8 million increase in salaries and employee benefits from increased professional services and customer support headcount, a \$0.5 million increase in stock-based compensation expense relating to our increased headcount, a \$0.5 million increase in temporary staff and consulting costs associated with improvements to our data center operations and a \$1.2 million increase in depreciation expense due to capital additions.

Gross profit and gross margin increased by \$39.0 million and 5.7 percentage points, respectively, in the year ended December 31, 2012 as compared to the same period of 2011 as revenues increased by \$46.4 million and cost of revenues increased by \$7.3 million. The increase in the gross margin for 2012 is primarily a result of our ability to utilize existing infrastructure to accommodate revenue growth and the fixed nature of certain costs such as intangible amortization. Cost of revenues increased primarily due to a \$2.6 million increase in third-party royalty expenses to support the increased revenues, a \$2.6 million increase in salaries and employee benefits from increased professional services and customer support headcount as well as the increase in headcount in hiring former DMD employees following the DMD acquisition in August 2011, a \$1.0 million increase in consulting costs associated with improvements to our data center operations and a \$0.9 million increase in depreciation expense due to property and equipment additions. The increase in cost of revenues was partially offset by the capitalization of \$1.0 million in compensation and consulting costs associated with data center improvements.

Sales and marketing expenses increased by \$3.4 million, or 19.3%, in the year ended December 31, 2013 as compared to the same period of 2012. This increase was primarily due to a \$1.9 million increase in salaries and employee benefits as well as a \$0.6 million increase in stock-based compensation expense, both reflecting an increase in headcount as we continued to grow our sales and marketing departments in an effort to increase our market share. Additionally, travel and entertainment expenses in support of our sales function increased by \$0.5 million, and technology and telecommunications expenses incurred in support of our sales function increased by \$0.3 million.

Sales and marketing expenses increased by \$5.8 million, or 47.5%, in the year ended December 31, 2012 as compared to the same period of 2011. This increase was primarily due to a \$2.2 million increase in salaries and employee benefits reflecting additional headcount as we have grown our sales department in order to address anticipated demand for our software solutions and additional headcount from the hiring of former DMD employees in August 2011, a \$1.2 million increase in commissions commensurate with the increase in revenues, a \$0.8 million increase due to the increased level of sales and marketing activities in 2012 as compared to the prior-year period including our Awesome User Summit in the fourth quarter of 2012 and a \$0.6 million increase in amortization of acquired intangible assets related to the DMD acquisition which occurred in August 2011.

Research and Development

	Year ended December 31,		
	2013	2012	2011
	(in thousands except percentages)		
Research and development	\$ 24,695	\$ 18,053	\$ 12,975
Research and development	19.2%	17.7%	23.4%

Research and development expenses increased by \$6.6 million, or 36.8%, in the year ended December 31, 2013 compared to the same period of 2012. The increase was primarily due to a \$3.8 million increase in salaries and employee benefits reflecting an increase in headcount, a \$1.9 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and stock option and RSU grants made to new and existing employees and a \$0.5 million increase in the use of consultants.

Research and development expenses increased by \$5.1 million, or 39.1%, in the year ended December 31, 2012 compared to the same period of 2011. The increase was primarily due to a \$2.8 million increase in salaries and employee benefits reflecting an increase in headcount which included the hiring of former DMD employees in August 2011, a \$1.1 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 as well as stock option grants made to new employees and a \$0.6 million increase in the use of consultants.

General and Administrative

	Year ended December 31,		
	2013	2012	2011
	(in thousands except percentages)		
General and administrative	\$ 30,853	\$ 21,601	\$ 12,900
General and administrative	24.0%	21.2%	23.2%

General and administrative expenses increased by \$9.3 million, or 42.8%, in the year ended December 31, 2013 as compared to the same period of 2012. This increase was primarily due to a \$4.4 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and stock option and RSU grants made to new and existing employees, a \$1.4 million increase in the use of consultants and temporary contractors for infrastructure and compliance projects, a \$1.1 million increase in technology expenses relating to licenses and support for software used to manage our business, a \$0.9 million increase in fees to professional service firms for accounting, tax, and investor relations services and a \$0.4 million increase in depreciation expenses resulting from overall growth of our business and headcount.

General and administrative expenses increased by \$8.7 million, or 67.4%, in the year ended December 31, 2012 as compared to the same period of 2011. This increase was primarily due to a \$3.6 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 as well as stock option grants made to new employees, a \$1.3 million increase in salaries and other employee benefits due to an increase in headcount, which included the hiring of former DMD employees, a \$1.4 million increase in bonus expense due to a greater number of employees eligible for bonus pay as well as improved operating performance of the Company, a \$1.1 million increase in hardware and software expenses associated with infrastructure upgrades, a \$0.6 million increase in the use of consultants and temporary workers, a \$0.3 million increase in credit card processing fees resulting from higher sales volumes and a \$0.2 million increase in depreciation expense due to recent increases in capital expenditures. The increases were offset by a \$0.5 million decrease in legal fees due to decreased usage of outside legal services and a \$0.4 million decrease in bad debt expenses resulting from the shift in the mix of our customer base from mortgage brokerages to mortgage lenders and improvement in the economy.

Other (Expense) Income, Net

Other income (expense), net includes imputed interest expense related to the DMD acquisition holdback liability and interest income from notes receivable and investments. The amounts were not significant in the years ended December 31, 2013, 2012 and 2011.

Liquidity and Capital Resources

As of December 31, 2013, we had cash, cash equivalents and short-term investments of \$79.8 million and long-term investments of \$56.3 million. Cash and cash equivalents consist of cash and money market accounts. Both short and long-term investments consist of corporate bonds and obligations, certificates of deposit, municipal obligations, U.S. government notes and U.S. government agency securities.

We believe that our existing cash, cash equivalents and short-term investments will be sufficient to fund capital expenditures, operating expenses and other cash requirements for at least the next 12 months. We may enter into acquisitions in the future, which could require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

The following table sets forth our statement of cash flows data for the periods presented:

	Year ended December 31,		
	2013	2012	2011
	(in thousands)		
Net cash provided by operating activities	\$ 29,248	\$ 27,753	\$ 6,372
Net cash used in investing activities	\$ (52,314)	\$ (69,121)	\$ (21,268)
Net cash provided by financing activities	\$ 12,414	\$ 61,750	\$ 24,279
Net increase (decrease) in cash and cash equivalents	\$ (10,652)	\$ 20,382	\$ 9,383

Operating Activities

Cash provided by operating activities increased by \$1.5 million from \$27.8 million in 2012 to \$29.2 million in 2013. In the consolidated statements of cash flows, cash provided by operating activities is presented as net income adjusted for non-cash expense items and changes in operating assets and liabilities. Net income decreased by \$6.9 million for the year ended December 31, 2013 as compared to the same period of

2012. The net contribution of non-cash expense items to cash provided by operating activities increased by \$3.3 million for the year ended December 31, 2013 as compared to the same period of 2012. The net contribution of changes in operating assets and liabilities to cash provided by operating activities increased by \$5.1 million for the year ended December 31, 2013 as compared to the same period of 2012.

Contributing to the increase in the net contribution of non-cash expense items was a \$7.4 million increase in stock-based compensation expense, primarily due to Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and new stock option and RSUs grants made to new and existing employees, offset in part by reductions from fully vested, fully amortized stock options, which no longer impacted expense in 2013. Also contributing was a \$1.7 million in depreciation expense, primarily due to purchases of property and equipment for our data centers and for our new ERP system, which was placed into service during the fourth quarter of 2013. Additionally, amortization of investment premium increased by \$1.6 million due to purchases of short-term and long-term investments starting in the fourth quarter of 2012. Offsetting these contributors to cash provided by operating activities were excess tax benefits, which reduce cash provided by operating activities and increased by \$4.7 million primarily as a result of windfall tax benefits on the exercise of stock options, of which there were none in 2012. Also reducing cash provided by operating activities was the benefit from deferred income taxes, which increased by \$2.4 million, primarily due to increases to deferred taxes related to stock-based compensation, and the lack of a reduction in the deferred tax asset valuation allowance during 2013, as there was in 2012.

Changes in operating assets and liabilities resulted in a net increase of \$5.1 million to cash provided by operating activities in the year ended December 31, 2013 as compared to the same period in 2012. Our net accounts receivable balance fluctuates from period to period, depending on the timing of sales and billing activity, cash collections and changes to our allowance for doubtful accounts. The change in prepaid expenses and other current assets was primarily due to the timing of the payment for computer software licenses, as well as an increase in taxes receivable resulting from windfall tax benefits on the exercise of stock options. The change in deposits and other assets was due to deferred commission expenses which started in 2013 and timing of the payment for software licenses. The change in accounts payable and accrued and other liabilities was due to the timing of additional liabilities and payments in general, and does not reflect any significant change in the nature of accrued liabilities.

Cash provided by operating activities increased by \$21.4 million from \$6.4 million in 2011 to \$27.8 million in 2012. This increase was primarily due to an increase of net income of \$15.8 million for the year ended December 31, 2012 as compared to the same period of 2011. Additionally, stock-based compensation expense increased by \$5.2 million for the year ended December 31, 2012 as compared to the same period of 2011. This increase resulted from new grants and the increased market price per share of our common stock, offset in part by reductions from fully vested, fully amortized stock options. Additionally, the change in deferred tax assets and liabilities increased by \$1.1 million primarily due to the reduction in our deferred tax asset valuation allowance. Depreciation expense increased by \$1.2 million primarily due to purchases of property and equipment for our data center and amortization of other intangible assets increased by \$0.7 million primarily due to the acquisition of DMD. The increases were also offset by the increase in the excess tax benefit from exercise of stock options of \$2.0 million as well as the decrease in the provision for uncollectible accounts receivable of \$0.4 million.

Cash provided by operating activities is also affected by changes in operating assets and liabilities, which resulted in a net decrease of \$0.4 million to operating cash flows in the year ended December 31, 2012 as compared to the same period in 2011. Our net accounts receivable balance fluctuates from period to period, depending on the timing of sales and billing activity, cash collections and changes to our allowance for doubtful accounts. The change in prepaid expenses was due to the timing of the payment for insurance renewals, computer software licenses and computer equipment maintenance contracts as well as payments for prepaid maintenance related to computer hardware purchased for our data centers. The change in accounts payable and accrued and other liabilities was due to the timing of additional liabilities and specifically, to the payment of bonuses to employees prior to December 31, 2012.

Investing Activities

Our primary investing activities have consisted of purchases of investments, purchases of property and equipment specifically related to the build out of our data centers, as well as payments for acquisitions. Purchases of property and equipment may vary from period to period due to the timing of the expansion of our operations and certain software development projects subject to capitalization. We plan to continue to invest in technology hardware and software to support our growth and corporate infrastructure. Additionally, consistent with our acquisition strategy, we intend to continue pursuing additional strategic acquisitions.

Cash used in investing activities of \$52.3 million for the year ended December 31, 2013 was primarily the result of \$44.2 million in net purchases of investments, \$6.1 million for purchases of property and equipment mainly for our data centers and a \$3.0 million holdback payment relating to the acquisition of DMD. This was partially offset by collections of \$1.0 million on an outstanding note receivable.

Cash used in investing activities of \$69.1 million for the year ended December 31, 2012 was primarily the result of \$58.1 million in net purchases of investments, \$8.1 million for purchases of property and equipment mainly for our data centers and a \$2.9 million holdback payment relating to the acquisition of DMD.

Cash used in investing activities of \$21.3 million for the year ended December 31, 2011 was primarily the result of \$18.2 million in cash payments related to the acquisitions of DMD and MPS as well as purchases of property and equipment of \$3.7 million primarily related to computer equipment and software to support the growth of our business.

Financing Activities

Financing activities have consisted primarily of proceeds from our public offerings of common stock in 2011 and 2012, net of offering costs. Additional cash has been provided from the exercise of stock options as well as from the effect of excess tax benefits from exercises of stock options.

Cash provided by financing activities of \$12.4 million for the year ended December 31, 2013 consisted primarily of \$6.5 million in proceeds from the exercise of stock options and \$6.7 million in excess tax benefit from exercise of stock options.

Cash provided by financing activities of \$61.8 million for the year ended December 31, 2012 consisted primarily of \$55.5 million in proceeds from our follow-on public offering, net of offering costs, \$4.3 million in proceeds from the exercise of stock options and \$2.0 million in excess tax benefit from exercise of stock options.

Cash provided by financing activities of \$24.3 million for the year ended December 31, 2011 consisted primarily of \$23.1 million in proceeds from our initial public offering, net of offering costs, and \$1.3 million in proceeds from the exercise of stock options.

Contractual Obligations

As of December 31, 2013, our contractual payment obligations are as follows:

	Payment due by period (as of December 31, 2012)			
Acquisition holdback, net of discounts	\$ 1,965	\$ 1,965	\$ —	\$ —
Capital lease obligations	1,036	1,036	—	—
Operating lease obligations	3,026	1,834	842	350
Purchase obligations	3,160	1,267	1,893	—
Total	\$ 9,187	\$ 6,102	\$ 2,735	\$ 350

Acquisition holdback, net of discounts is related to the acquisition of DMD. See Notes 5 and 8 of the Notes to Consolidated Financial Statements.

Purchase obligations are associated with agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum services to be used; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Obligations under contracts that we can cancel without a significant penalty are not included in the table above. See Note 8 of the Notes to Consolidated Financial Statements.

Capstone Publishing, LLC

ABC , Inc.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	December 31,	
	2013	2012
Assets		
Current assets		
Cash and cashequivalents	\$ 33,462	\$ 44,114
Short-term investments	46,325	16,243
Accounts receivable, net of allowances for doubtful accounts of \$81 and \$74 as of December 31, 2013 and December 31, 2012, respectively	12,024	9,753
Prepaid expenses and other current assets	6,473	3,601
Note receivable	—	1,000
Total current assets	98,284	74,711
Property and equipment, net	12,751	9,494
Long-term investments	56,285	43,728
Other intangible assets, net	5,089	6,531
Goodwill	51,051	51,051
Deposits and other assets	5,112	100
Total assets	\$ 228,572	\$ 185,615
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 3,783	\$ 2,039
Accrued and other current liabilities	10,224	6,044
Acquisition holdback, net of discount	1,965	2,948
Deferred revenue	4,752	4,896
Total current liabilities	20,724	15,927
Acquisition holdback, net of current portion and discount	—	1,911
Other long-term liabilities	952	915
Total liabilities	21,676	18,753
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, \$0.0001 par value per share; 140,000,000 authorized shares, 27,624,025 and 26,058,533 shares issued and outstanding as of December 31, 2013 and December 31, 2012, respectively	3	3
Additional paid-in capital	212,043	184,616
Accumulated other comprehensive loss	(34)	(65)
Accumulated deficit	(5,116)	(17,692)
Total stockholders' equity	206,896	166,862
Total liabilities and stockholders' equity	\$ 228,572	\$ 185,615

See accompanying notes to these consolidated financial statements.

ABC, Inc.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, except share and per share amounts)

	Year ended December 31,		
	2013	2012	2011
Revenues	\$ 128,481	\$ 101,845	\$ 55,494
Cost of revenues	32,748	23,114	15,784
Gross profit	95,733	78,731	39,710
Operating expenses:			
Sales and marketing	21,331	17,887	12,126
Research and development	24,695	18,053	12,975
General and administrative	30,853	21,601	12,900
Total operating expenses	76,879	57,541	38,001
Income from operations	18,854	21,190	1,709
Other income (expense), net	460	(43)	76
Income before income taxes	19,314	21,147	1,785
Income tax provision (benefit)	6,738	1,683	(1,835)
Net income	\$ 12,576	\$ 19,464	\$ 3,620
Net income per share of common stock:			
Basic	\$ 0.47	0.83	0.23
Diluted	\$ 0.44	0.76	0.18
Weighted average common shares used in computing net income per share of common stock:			
Basic	26,581,962	23,523,222	15,618,053
Diluted	28,502,403	25,537,192	20,649,451
Net income	\$ 12,576	\$ 19,464	\$ 3,620
Other comprehensive income, net of taxes			
Unrealized gain (loss) on investments	31	(65)	—
Comprehensive income	\$ 12,607	\$ 19,399	\$ 3,620

Capstone Publishing, LLC

ABC , Inc.

CONSOLIDATED STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY
(DEFICIT)

(in thousands, except share amounts)

	Redeemable Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated		Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount		Other Comprehensive Loss	Accumulated Deficit	
Balances, December 31, 2010	11,770,472	82,672	3,629,662	—	8,951	—	(40,776)	(31,825)
Issuance of common stock for cash upon exercise of stock options	—	—	414,583	—	1,185	—	—	1,185
Issuance of common stock upon exercise of stock options in exchange for an employee note receivable	—	—	29,163	—	—	—	—	—
Issuance of common stock upon exercise of warrant	—	—	175,710	—	125	—	—	125
Issuance of common stock in connection with IPO, net	—	—	5,000,000	—	21,392	—	—	21,392
Conversion of preferred stock to common stock in connection with IPO	(11,770,472)	(82,672)	11,770,472	2	82,670	—	—	82,672
Stock-based compensation	—	—	—	—	1,680	—	—	1,680
Excess tax benefit from exercise of stock options	—	—	—	—	9	—	—	9
Net income	—	—	—	—	—	—	3,620	3,620
Balances, December 31, 2011	—	—	21,019,590	2	116,012	—	(37,156)	78,858
Issuance of common stock under stock incentive plans	—	—	1,447,456	—	3,516	—	—	3,516
Issuance of common stock under employee stock purchase plan	—	—	126,242	—	742	—	—	742
Issuance of common stock in connection with public offering, net	—	—	3,465,245	1	55,530	—	—	55,531
Stock-based compensation	—	—	—	—	6,849	—	—	6,849
Excess tax benefit from exercise of stock options	—	—	—	—	1,967	—	—	1,967
Unrealized gain (loss) on investments	—	—	—	—	—	(65)	—	(65)
Net income	—	—	—	—	—	—	19,464	19,464
Balances, December 31, 2012	—	—	26,058,533	3	184,616	(65)	(17,692)	166,862
Issuance of common stock under stock incentive plans	—	—	1,462,566	—	4,623	—	—	4,623
Shares withheld for employee taxes related to vested restricted stock units	—	—	(6,344)	—	(174)	—	—	(174)
Issuance of common stock under employee stock purchase plan	—	—	109,270	—	1,922	—	—	1,922
Stock-based compensation	—	—	—	—	14,390	—	—	14,390
Excess tax benefit from exercise of stock options	—	—	—	—	6,666	—	—	6,666
Unrealized gains on investments	—	—	—	—	—	31	—	31
Net income	—	—	—	—	—	—	12,576	12,576
Balances, December 31, 2013	—	\$ —	27,624,025	\$ 3	\$ 212,043	\$ (34)	\$ (5,116)	\$ 206,896

See accompanying notes to these consolidated financial statements.

ABC , Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year ended December 31,		
	2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 12,576	\$ 19,464	\$ 3,620
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	4,845	3,144	1,964
Provision for uncollectible accounts receivable	32	70	469
Amortization of other intangible assets	1,442	1,635	896
Amortization of discount related to holdback	106	186	80
Amortization of investment premium	1,614	—	—
Stock-based compensation expense	14,259	6,849	1,680
Loss on sale of property and equipment	—	19	—
Excess tax benefit from exercise of stock options	(6,666)	(1,967)	—
Deferred income taxes	(2,987)	(559)	(1,654)
Changes in operating assets and liabilities:			
Accounts receivable	(2,303)	(3,004)	(2,584)
Prepaid expenses and other current assets	3,466	(1,506)	(650)
Deposits and other assets	(1,353)	50	621
Accounts payable	907	500	479
Accrued, other current and other liabilities	3,437	2,538	1,130
Deferred revenue	(127)	334	321
Net cash provided by operating activities	29,248	27,753	6,372
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of property and equipment	(6,092)	(8,121)	(3,688)
Purchase of investments	(101,121)	(65,811)	(6,228)
Maturities of investments	56,899	7,708	6,851
Acquisitions, net of cash acquired	(3,000)	(2,907)	(18,188)
Other investing activities, net	1,000	10	(15)
Net cash used in investing activities	(52,314)	(69,121)	(21,268)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from public offerings, net of commissions	—	55,964	27,900
Offering costs paid during the period	—	(433)	(4,824)
Payment of capital lease obligations	(624)	(6)	(116)
Proceeds from issuance of common stock under employee stock plans	6,546	4,258	1,310
Tax payments related to shares withheld for vested restricted stock units	(174)	—	—
Excess tax benefit from exercise of stock options	6,666	1,967	9
Net cash provided by financing activities	12,414	61,750	24,279
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(10,652)	20,382	9,383
CASH AND CASH EQUIVALENTS, Beginning of period	44,114	23,732	14,349
CASH AND CASH EQUIVALENTS, End of period	\$ 33,462	\$ 44,114	\$ 23,732
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 268	\$ 356	\$ 3
Cash paid for income taxes	\$ 4,582	\$ 212	\$ 193
Supplemental disclosure of non-cash investing and financing activities:			
Fixed asset purchases not yet paid	\$ 884	\$ 186	\$ 801
Stock-based compensation capitalized to property and equipment	\$ 131	\$ —	\$ —

Acquisition of property and equipment under capital leases	\$ 1,271	\$ —	\$ —
Conversion of preferred stock to common stock	\$ —	\$ —	\$ 82,670

See accompanying notes to these consolidated financial statements.



ABC , Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 — Description of Business

ABC, Inc. (the “Company” or “ABC”) is a leading provider of on-demand software solutions and services for the residential mortgage industry in the United States . Its mortgage management solutions help streamline and automate the process of originating and funding new mortgage loans, thereby increasing efficiency, improving loan quality, facilitating regulatory compliance and reducing documentation errors while providing one system of record for loans.

NOTE 2 — Basis of Presentation and Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of ABC and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

Certain reclassifications have been made to prior period amounts to conform to current period presentation. Such reclassifications have no effect on revenues, income from operations or net income as previously reported.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management evaluates estimates on a regular basis including those relating to revenue recognition, the allowance for doubtful accounts, goodwill, other intangible assets, the valuation of deferred income taxes, stock-based compensation and unrecognized tax benefits, among others. Actual results could differ from those estimates and such differences may have a material impact on the Company’s consolidated financial statements and footnotes.

Cash and Cash Equivalents

All highly liquid investments with original maturities of 90 days or less are considered to be cash equivalents. Cash and cash equivalents are recorded at cost, which approximates fair value.

Fair Value of Financial Instruments

The fair values of the Company’s cash and cash equivalents, accounts receivable, notes receivable and accounts payable approximate their carrying values due to the short maturities of the instruments. The fair value of the Company’s capital lease obligations approximates the carrying value due to the short-term maturities of the leases.

All of the Company’s investments that have maturities of greater than 90 days are classified as available-for-sale and are carried at fair value. The Company invests excess cash primarily in investment-grade interest-bearing securities such as money market accounts, certificates of deposit, commercial paper, corporate bonds, municipal and government agency obligations and guaranteed obligations of the U.S. government, all of which are subject to minimal credit and market risks. Fair value is determined based on quoted market rates when observable or utilizing data points that are observable, such as quoted prices, interest rates and yield curves. The cost of available-for-sale marketable securities sold is based on the specific identification method. Unrealized gains and losses, net of tax, are reported in stockholders’ equity as accumulated other comprehensive loss. Realized gains and losses are included in other income (expense), net Interest and dividends are included in other income (expense), net when they are earned.

Allowance for Doubtful Accounts

The Company analyzes individual trade accounts receivable by considering historical bad debts, customer creditworthiness, current economic trends, changes in customer payment terms and collection trends when evaluating the adequacy of the allowance

for doubtful accounts. Allowances for doubtful accounts are recognized in the period in which the associated receivable balance is not considered recoverable. Any change in the assumptions used in analyzing accounts receivable may result in changes to the allowance for doubtful accounts and is recognized in the period in which the change occurs. The Company writes off a receivable when all rights, remedies and recourses against the account and its principals are exhausted and records a benefit when previously reserved accounts are collected.

Concentration of Credit Risk

The financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments and accounts receivable. The Company's cash and cash equivalents are deposited with major financial institutions in the United States. At times, such deposits may be in excess of insured limits. Management believes that the Company's investments in cash equivalents and available-for-sale investments are financially sound and have minimal credit risk. The Company's accounts receivable are derived from revenue earned from customers located in the United States. The Company had no customers that represented 10% or more of revenues for the years ended December 31, 2013, 2012 and 2011. No customer represented more than 10% of accounts receivable as of December 31, 2013 and 2012.

Software and Website Development Costs

The Company capitalizes internal and external costs incurred to develop internal-use software and website applications. Capitalized internal costs include salaries, benefits and stock-based compensation charges for employees that are directly involved in developing the software or website application, and depreciation of assets used in the development process. Capitalized external costs include third-party consultants involved in the development process, as well as other direct costs incurred as part of the development process.

Capitalization of costs begins when the preliminary project stage is completed, and management authorizes and commits to funding a project and it is probable that the project will be completed and the software or website application will be used to perform the function intended. Internal and external costs incurred as part of the preliminary project stage are expensed as incurred.

Capitalization ceases at the point at which the project is substantially complete and ready for its intended use, after all substantial testing is completed. Internal and external training costs and maintenance costs during the post-implementation operation stage are expensed as incurred.

Internal-use software is amortized on a straight-line basis over its estimated useful life, generally three years. Management evaluates the useful lives of these assets on an annual basis and tests for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets. The capitalized costs are included in "Property and equipment, net" in the accompanying consolidated balance sheets. For the years ended December 31, 2013 and 2012, the Company capitalized software and website application development costs of \$5.0 million and \$0.5 million, respectively. There were no such costs capitalized in the year ended December 31, 2011. There was \$69,000 in amortization of capitalized internal-use software and website development costs recorded during the year ended December 31, 2013 and no such amortization recorded during the years ended December 31, 2012 and 2011.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and are depreciated on a straight-line basis over their estimated useful lives, which is generally three years. Leasehold improvements are amortized over the shorter of the asset's useful life or term of the lease.

Goodwill

The Company records goodwill in a business combination when the consideration paid exceeds the fair value of the net assets acquired. Goodwill is not amortized, but is tested for impairment at least annually in the fourth quarter of the Company's fiscal year, or whenever changes in circumstances indicate that the fair value of a reporting unit is less than its carrying amount, including goodwill. The annual test is performed at the reporting unit level using a fair-value based approach. The Company's operations are organized as one reporting unit. In testing for a potential impairment of goodwill, the Company first compares the carrying value of assets and liabilities to the estimated fair value. If estimated fair value is less than carrying value, then potential impairment exists. The amount of any impairment is then calculated by determining the implied fair value of goodwill using a hypothetical purchase price allocation. Impairment is equivalent to any excess of goodwill carrying value over its implied fair value.

The process of evaluating the potential impairment of goodwill requires significant judgment at many points during the analysis, including calculating fair value of each reporting unit based on estimated future cash flows and discount rates to be applied.

The Company completed its annual impairment tests during the fourth quarters of 2013, 2012 and 2011 and determined that goodwill was not impaired.

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Other Intangible Assets

Other intangible assets are stated at cost less accumulated amortization. Other intangible assets include developed technology, trade names and customer lists and contracts. Intangible assets with finite lives are amortized on a straight-line basis over the estimated periods of benefit, as follows:

Developed technology	3-5 years
Trade names	3 years
Customer lists and contracts	1-9 years

The Company evaluates its finite-lived intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to future undiscounted net cash flows expected to be generated by the asset group. If such assets are considered to be impaired, the impairment loss to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount and fair value less costs to sell. There have been no such impairments of finite-lived intangible assets for the years ended December 31, 2013, 2012 and 2011.

Impairment of Long-Lived Assets

The Company evaluates its long-lived assets for indications of possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. There has been no such impairment of long-lived assets for the years ended December 31, 2013, 2012 and 2011.

Revenue Recognition

The Company generates revenue primarily from on-demand and on-premise fees for software and related services. On-demand revenues are revenues generated from company-hosted software subscriptions that customers access through the Internet as well as revenues from a small number of customers that have opted to self-host a portion of the software but pay fees based on a per closed loan, or success, basis subject to monthly base fees, which the Company refers to as Success-Based Pricing. On-demand revenues are also comprised of software services sold transactionally and ABC Network transaction fees. On-premise revenues are revenues generated from maintenance services, sales of customer-hosted software licenses (except for customer-hosted Success-Based Pricing revenues, which are included in on-demand revenues described above), and professional services, which include consulting, implementation and training services. Sales taxes assessed by governmental authorities are excluded from revenue.

The Company commences revenue recognition when all of the following conditions are satisfied:

- There is persuasive evidence of an arrangement
- The service has been or is being provided to the customer
- The collection of the fees is reasonably assured; and
- The amount of fees to be paid by the customer is fixed or determinable.

On-Demand Revenues

Subscription Services and Usage-Based Fee Arrangements. Subscription services and usage-based fee arrangements generally include a combination of the Company's products delivered as software-as-a-service ("SaaS") and support services. These arrangements are non-cancelable and do not contain refund-type provisions. These revenues generally include the following:

SaaS Awesome Revenues. The Company offers web-based, on-demand access to Awesome for a monthly recurring fee. The Company provides the right to access its loan origination software and handles the responsibility of managing the servers, providing security, backing up the data and applying updates; however, except where customers self-host a portion of the software in a Success-Based Pricing structure, customers under SaaS arrangements may not take possession of the software at any time during the term of the agreement. Subscription revenues are recognized ratably over the contract terms beginning on the commencement date of each contract, which is the date the Company's service is made available to customers. Contracts generally range from one year to five years.

Alternatively, customers can elect to pay on a per closed loan, or success, basis. Success basis contracts generally have a term of one to five years and are subject to monthly base fees, which enable customers to close loans up to a contractually agreed-to minimum number of transactions, and additional closed loan fees, which are assessed for loans closed in excess of the minimum. Revenue is earned from both base fees and additional closed loan fees as the result of the customer's usage of Awesome. Monthly base fees are recognized over the respective monthly service period as the software is utilized. Additional closed loans fees are recognized when the loans are reported as

closed. This offering also includes Awesome CenterWise, Awesome Compliance Service and Awesome Docs Solution for Awesome as integrated components, which are combined elements of the arrangement that is delivered in conjunction with the SaaS Awesome offering and therefore is not accounted for separately.

Awesome CenterWise Revenues. Awesome CenterWise is a bundled offering of electronic document management (“EDM”) and websites used for customer relationship management. Generally, revenue is recognized for Awesome CenterWise after the service is rendered, except when Awesome CenterWise is automatically included as an integrated component of the SaaS Awesome offering, in which case the associated revenue is recognized as described above.

Services Revenues. The Company provides mortgage-related and other business services, including automated documentation preparation and compliance reports. Services revenues are recognized after the services are rendered.

Transaction Revenues. The Company has entered into agreements with various lenders, service providers and certain government agencies participating in the mortgage origination process that provide them access to, and ability to interoperate with, mortgage originators on the ABC Network. Under these agreements, the Company earns transaction fees when transactions are processed through the ABC Network. Transaction revenues are recognized when there is evidence that the qualifying transactions have occurred on the ABC Network and collection of the resulting receivable is reasonably assured.

On-Premise Revenues

With the exception of revenue from customers that self-host a portion of the software in a Success-Based Pricing structure (which is recognized as described above), revenue from the sale of software licenses is recognized in the month in which the required revenue recognition criteria are met, generally in the month in which the software is delivered. Revenue from the sale of maintenance services and professional services is recognized over the period in which the services are provided.

Deferred Revenue

Deferred revenue represents billings or payments received in advance of revenue recognition and is recognized as the revenue recognition criteria are met. Balances consist primarily of maintenance and professional services not yet provided as of the balance sheet date. Deferred revenue that will be recognized during the succeeding 12 month period is recorded as current deferred revenue, and the remaining portion is recorded as other long-term liabilities.

Warranties and Indemnification

The Company provides a warranty for its software products and services to its customers and accounts for its warranties as a contingent liability. The Company’s software is generally warranted to perform substantially as described in the associated product documentation. The Company’s services are generally warranted to be performed consistent with industry standards. If there is a failure of such warranties, the Company generally is obligated to repair or replace the product or service or correct it to conform to the warranty provision. If the Company is unable to do so, the customer is entitled to terminate the agreement with the Company. With respect to Awesome Compliance Service, the Company provides a limited warranty, which limits its liability to the reimbursement for losses incurred by a customer due to fines, penalties or judgments imposed or levied upon a customer as a result of a violation of a specific law, rule or regulation resulting from an error in the provision of the Company’s Awesome Compliance Service. The Company’s maximum exposure is limited under its services agreements to the greater of the total service fees paid by a customer for such services during the specified period preceding the relevant claim, typically six to 12 months , or a specified dollar amount ranging from \$50,000 to \$5.0 million . The Company has not historically incurred any significant claims and maintains a total of \$10.0 million in professional liability insurance coverage. The Company has not provided for a warranty accrual as of December 31, 2013 or 2012 . To date, the Company’s product warranty expense has not been significant.

The Company generally agrees to indemnify its customers against legal claims that the Company’s software products infringe certain third-party intellectual property rights and accounts for its indemnification obligations as a contingent liability. In the event of such a claim, the Company is obligated to defend its customer against the claim and to either settle the claim at the Company’s expense or pay damages that the customer is legally required to pay to the third-party claimant. In addition, in the event of an infringement, the Company agrees to modify or replace the infringing product, or, if those options are not reasonably possible, to refund the cost of the software, as pro-rated over a period of years. To date, the Company has not been required to make any payment resulting from infringement claims asserted against its customers. The Company has not recorded a liability for infringement costs as of December 31, 2013 or 2012.

The Company has obligations under certain circumstances to indemnify each member of the Company’s board of directors against judgments, fines, settlements and expenses related to claims against such directors and otherwise to the fullest extent permitted under Delaware law and the Company’s bylaws and certificate of incorporation.

Cost of Revenues

The Company's cost of revenues consists primarily of salaries, benefits and related costs (including stock-based compensation), allocated facilities costs, customer support, data centers, expenses for document preparation, income verification and compliance services, depreciation on computer equipment used in supporting the ABC Network, the Company's SaaS Awesome and Awesome CenterWise offerings, amortization of acquired intangible assets directly involved in revenue producing activities and professional services associated with implementation of software.

Research and Development Costs

Research and development costs are expensed as incurred.

Advertising Expenses

The Company expenses advertising costs as incurred. Advertising expenses for the years ended December 31, 2013, 2012 and 2011 were \$0.4 million, \$0.3 million, and \$0.3 million, respectively.

Other Income (Expense), Net

Other income (expense), net consisted of the following:

	Year ended December 31,		
	2013	2012	2011
	(in thousands)		
Interest income	650	146	159
Net realized loss on investments	(55)	—	—
Interest expense	(135)	(189)	(83)
Total other income (expense), net	460	(43)	76

Comprehensive Income

Comprehensive income consists of net income and other comprehensive gain (loss). Other comprehensive gain (loss) includes certain changes in equity that are excluded from net income, specifically unrealized gains and losses on available-for-sale investments. There were no reclassifications out of accumulated other comprehensive income ("AOCI") that affected net income during the years ended December 31, 2013 and 2012.

NOTE 3 — Net Income Per Share of Common Stock

Net income per share of common stock is calculated by dividing net income by the weighted average shares of common stock outstanding during the period. Diluted net income per share of common stock is calculated by dividing net income by the weighted average shares of common stock outstanding and potential shares of common stock during the period. Potential shares of common stock include dilutive shares attributable to the assumed exercise of stock options, warrants and employee stock purchase plan shares using the treasury stock method, and RSUs, if dilutive.

The components of net income per share of common stock were as follows:

	Year ended December 31,		
	2013	2012	2011
(in thousands, except share and per share amounts)			
Net income	\$ 12,576	\$ 19,464	\$ 3,620
Basic shares:			
Weighted average common shares outstanding	26,581,962	23,523,222	15,618,053
Diluted shares:			
Weighted average shares used to compute basic net income per share	26,581,962	23,523,222	15,618,053
Effect of potentially dilutive securities:			
Employee stock options, RSUs, Performance Awards and ESPP shares	1,920,441	2,013,970	5,031,398
Weighted average shares used to compute diluted net income per share	28,502,403	25,537,192	20,649,451
Net income per share:			
Basic	\$ 0.47	\$ 0.83	\$ 0.23
Diluted	\$ 0.44	\$ 0.76	\$ 0.18

NOTE 4 — Financial Instruments and Fair Value Measurements

Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are classified and disclosed in one of the following three categories:

Level 1— Valuations based on quoted prices in active markets for identical assets or liabilities.

Level 2— Valuations based on other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3— Valuations based on inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the assets or liabilities.

The following tables set forth by level within the fair value hierarchy the Company's financial assets that were accounted for at fair value on a recurring basis, according to the valuation techniques the Company used to determine their values:

	Fair value at December 31, 2013	Fair value measurements using inputs considered as		
		Level 1	Level 2	Level 3
(in thousands)				
Money market funds	\$ 16,431	\$ 16,431	\$ —	\$ —
Corporate notes and obligations	26,774	—	26,774	—
Certificates of deposit	14,920	—	14,920	—
Municipal obligations	3,830	—	3,830	—
U.S. government and government agency obligations	60,018	11,428	48,590	—
	\$ 121,973	\$ 27,859	\$ 94,114	\$ —

	Fair value at December 31, 2012	Fair value measurements using inputs considered as		
		Level 1	Level 2	Level 3
Money market funds	\$ 36,453	\$ 36,453	\$ —	\$ —
Corporate notes and obligations	39,148	—	39,148	—
Municipal obligations	6,230	—	6,230	—
U S government agency obligations	15 048	4 711	10 337	—

Financial instruments include cash, cash equivalents and investments including investment-grade interest-bearing securities such as money market accounts, certificates of deposit, commercial paper, corporate bonds, municipal and government agency obligations and guaranteed obligations of the U.S. government. The Company classifies its money market funds that are specifically backed by debt securities and U.S. government obligations as Level 1 instruments due to the use of observable market prices for identical securities that are traded in active markets.

When we use observable market prices for identical securities that are traded in less active markets, we classify our marketable financial instruments as Level 2. When observable market prices for identical securities are not available, we price our marketable financial instruments using non-binding market consensus prices that are corroborated with observable market data; quoted market prices for similar instruments; or pricing models with all significant inputs derived from or corroborated with observable market data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs and, to a lesser degree, unobservable market inputs. We corroborate non-binding market consensus prices with observable market data as such data exists.

As of December 31, 2013 and December 31, 2012, the Company did not have any assets or liabilities that were valued using Level 3 inputs. For the years ended December 31, 2013, 2012 and 2011, there were no transfers of financial instruments between Level 1, Level 2 or Level 3 classifications.



For the years ended December 31, 2013, 2012 and 2011, the Company recognized interest income from financial instruments of \$2.1 million, \$0.2 million and \$0.1 million, respectively. Gross realized gains and gross realized losses from the sale of investments were not significant during the years ended December 31, 2013, 2012 and 2011.

The carrying amounts, gross unrealized gains and losses and estimated fair value of cash and cash equivalents and both short and long-term investments consisted of the following:

Cash and Cash Equivalent

Cash	\$ 14,092	\$ —	\$ —	\$ 14,092
Money market funds	16,431	—	—	16,431
U.S. government agency securities	2,939	—	—	2,939
	<u>\$ 33,462</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 33,462</u>
Investments:				
Corporate notes and obligations	\$ 26,770	\$ 17	\$ (13)	\$ 26,774
Certificates of deposit	14,945	1	(26)	14,920
Municipal obligations	3,827	5	(2)	3,830
U.S. government notes	11,430	3	(5)	11,428
U.S. government agency securities	45,672	12	(26)	45,658
	<u>\$ 102,644</u>	<u>\$ 38</u>	<u>\$ (72)</u>	<u>\$ 102,610</u>

The following table shows the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position:

	December 31, 2013					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized losses	Fair Value	Unrealized losses	Fair Value	Unrealized losses
	(in thousands)					
Corporate notes and obligations	\$ 6,403	\$ (13)	\$ —	\$ —	\$ 6,403	\$ (13)
Certificates of deposit	12,714	(26)	—	—	12,714	(26)
Municipal obligations	552	(2)	—	—	552	(2)
U.S. government notes	4,361	(5)	—	—	4,361	(5)
U.S. government agency securities	20,614	(26)	—	—	20,614	(26)
	<u>\$ 44,644</u>	<u>\$ (72)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 44,644</u>	<u>\$ (72)</u>
Corporate notes and obligations	\$ 35,435	\$ (63)	\$ —	\$ —	\$ 35,435	\$ (63)
Municipal obligations	5,314	(11)	—	—	5,314	(11)
U.S. government notes	3,577	(1)	—	—	3,577	(1)
	<u>\$ 44,326</u>	<u>\$ (75)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 44,326</u>	<u>\$ (75)</u>

The following table summarizes the maturities of the Company’s investments at December 31, 2013:

	<u>Carrying or fair value</u>
	<u>(in thousands)</u>
2014	\$ 46,325
2015	39,921
2016	16,364
Total	<u>\$ 102,610</u>

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations.



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The cost of property and equipment at December 31, 2013 included a total of \$1.0 million of computer equipment and \$0.5 million of software under capital leases. Accumulated amortization relating to computer equipment and software under capital leases totaled \$0.6 million at December 31, 2013. There were no assets under capital leases as of December 31, 2012.

Depreciation expense for the years ended December 31, 2013, 2012 and 2011 was \$4.8 million, \$3.1 million and \$2.0 million, respectively. Amortization of assets under capital leases, which is included in depreciation expense, was \$0.6 million for the year ended December 31, 2013, and was not significant for the years ended December 31, 2012 and 2011.

Note Receivable

On September 30, 2009, the Company advanced \$1.0 million to a private company in the form of a secured promissory note receivable, scheduled to mature on September 30, 2012. On September 18, 2012 the note was extended through September 30, 2013 pursuant to the terms of the note. The note receivable was secured by all tangible and intangible assets and property of the private company and bore interest at 10% per annum with interest only payments through the extension date, at which time the principal balance and any remaining accrued interest was due and payable. The Company recorded interest income of \$78,000, \$100,000 and \$100,000 for the years ended December 31, 2013, 2012, and 2011, respectively. The private company repaid the note in full in October 2013.

Other Intangible Assets

Other intangible assets, net, consisted of the following:

	(in thousands)			(in years)
Developed technology	\$ 1,874	\$ (1,500)	\$ 374	1.2
Trade names	260	(192)	68	1.0
Customer relationships and contracts	7,300	(2,653)	4,647	5.1
	<u>\$ 9,434</u>	<u>\$ (4,345)</u>	<u>\$ 5,089</u>	4.8

	December 31, 2012			
	Gross carrying amount	Accumulated amortization	Net intangibles	Weighted Average Remaining Useful Life
		(in thousands)		(in years)
Developed technology	\$ 1,874	\$ (1,170)	\$ 704	2.2
Trade names	260	(124)	136	2.0
Customer relationships and contracts	7,300	(1,609)	5,691	6.0
	<u>\$ 9,434</u>	<u>\$ (2,903)</u>	<u>\$ 6,531</u>	5.5

Amortization expense associated with other intangible assets was \$1.4 million, \$1.6 million and \$0.9 million for the years ended December 31, 2013, 2012 and 2011, respectively.

Minimum future amortization expense for other intangible assets at December 31, 2013 was as follows:

	(in thousands)
2014	\$ 1,405
2015	1,032
2016	928
2017	928
2018	266
Thereafter	530
	<u>5,089</u>

Goodwill

There was no change to goodwill in the years ended December 31, 2012 and 2013.

Accrued and Other Current Liabilities

Accrued and other liabilities consisted of the following:

	December 31,	
	2013	2012
	(in the usands)	
Accrued payroll and related expenses	\$ 6,154	\$ 2,743
Accrued commissions	552	394
Accrued professional fees	503	647
Accrued royalties	725	620
Sales and other taxes	254	238
Income taxes	898	—
Other accrued expenses	1,138	1,402
	<u>\$ 10,224</u>	<u>\$ 6,044</u>

Deferred Revenue

Deferred revenues consisted of the following:

	December 31,	
	2013	2012
	(in the usands)	
Software maintenance	\$ 2,148	\$ 2,832
Professional services and training	1,725	1,512
Other	944	600
Total	4,817	4,944
Less portion included in other long-term liabilities	(65)	(48)
	<u>\$ 4,752</u>	<u>\$ 4,896</u>

NOTE 8 — Commitments and Contingencies

Leases

As of December 31, 2013, the Company leased six facilities under operating lease arrangements. The lease expiration dates range from May 2014 to December 2018. Certain leases contain escalation clauses calling for increased rents. The Company recognizes rent expense on a straight-line basis over the lease period and has recorded deferred rent for the difference between rent payments and rent expense recognized. An additional facility is leased on a month-to-month basis. Rent expense was \$1.6 million, \$1.2 million, and \$1.0 million for the years ended December 31, 2013, 2012 and 2011, respectively.

Purchase Commitments

Commitments for the purchase of services and licenses of third-party software totaled \$3.2 million at December 31, 2013 and are to be paid as follows: \$1.3 million in 2014, \$1.8 million in 2015 and \$0.1 million in 2016.

Legal Proceedings

On March 25, 2011, Industry Access Incorporated (“Industry Access”) filed a patent infringement lawsuit against us and another defendant in the U.S. District Court for the Central District of California. The complaint alleges, among other things, that certain aspects of our Awesome

loan management software system and related operations infringe a single patent, and seeks declaratory relief and unspecified damages from the defendants, including enhanced damages for willful infringement and reasonable attorneys' fees. On June 24, 2011, the Court issued an order requiring plaintiff to serve the complaint on all defendants within three days of the order. On June 28, 2011, plaintiff served us with the complaint and we filed its answer on August 5, 2011 denying all material allegations of the complaint. On November 18, 2011 the other defendant filed with the United States Patent and Trademark Office (the "PTO") a request for ex parte reexamination of Industry Access' US Patent No 7,769,681, which the PTO granted on February 14, 2012. On December 15, 2011, we filed a motion to stay the litigation pending the reexamination, which the Court granted on February 28, 2012. On October 9, 2012, the PTO issued the reexamination certificate. The Court granted a motion to dismiss the other defendant from this action on April 7, 2013 and lifted the stay on April 11, 2013. The parties are in the claims construction phase of the litigation with a claim construction hearing that was scheduled for December 2, 2013. Discovery is ongoing and the trial has been rescheduled for December 2014 as further discussed below.

On March 19, 2013, Industry Access filed a second patent infringement lawsuit against us in the U.S. District Court for the Central District of California. The complaint alleges, among other things, that our Awesome loan management software system, including the Awesome software, the ABC Network, Awesome Originator, Awesome Compliance Service, Awesome CenterWise, Awesome Electronic Document Management, Awesome Docs Solution and Awesome Product and Pricing Service, infringes U.S. Patent Nos. 8,117,120 and 8,145,563, which are continuations of U.S. Patent No. 7,769,681, asserted in the lawsuit described above. Plaintiff is seeking unspecified damages. On June 12, 2013, we filed a motion to dismiss or, in the alternative, to transfer this case to the Northern District of California, which the Court denied on September 18, 2013. Trial is set for December 2014.

On September 12, 2013, we filed a motion to relate and consolidate the two Industry Access lawsuits so that all of Industry Access' related patent infringement claims would be heard before the same judge on the same schedule. Industry Access responded to this motion on October 11, 2013. The Court granted our motion to consolidate on October 31, 2013. The Court has scheduled the claim construction hearing for June 2, 2014. Trial is set for December 2014.

We believe that we have substantial and meritorious defenses in the newly consolidated case and, if similar claims are pursued, we intend to defend these and similar claims vigorously.

We are also subject to various other legal proceedings and claims arising in the ordinary course of business. With respect to these matters and the litigations described above, we cannot predict the ultimate outcome of these legal proceedings and the amounts and ranges of potential damages associated with such proceedings cannot be estimated or assessed. An unfavorable outcome of these or the litigation could materially adversely affect our business, financial condition and results of operations.

NOTE 9 — Stockholders' Equity

On July 3, 2012, the Company sold 3,465,245 shares of its common stock and certain directors and executive officers of the Company (the "Selling Stockholders") sold an aggregate of 101,638 shares in an underwritten public offering pursuant to the Company's effective Registration Statement on Form S-3 (Registration No. 333-181980) at a public offering price of \$17.00 per share. The Company received the net proceeds from the sale of the shares offered by the Company of approximately \$55.5 million, after deducting underwriting discounts and commissions and offering expenses. The Company received no proceeds from the sale of shares offered by the Selling Stockholders.

On April 20, 2011, the Company sold 5,000,000 newly issued shares of common stock, par value \$0.0001 per share, at a price of \$6.00 per share in its initial public offering, or IPO. The Company received net proceeds from the IPO of approximately \$21.3 million after deducting underwriting discounts and commissions of \$2.1 million and offering expenses of \$6.6 million. In connection with the IPO, on April 14, 2011, the Company effected a 1-for-3 reverse stock split of all of its outstanding capital stock. Immediately prior to the consummation of the IPO on April 20, 2011, the Company effected the conversion of all of its 11,770,472 shares of outstanding redeemable convertible preferred stock into shares of common stock on a 1-for-1 basis. The post-IPO amended and restated certificate of incorporation of the Company authorizes 140,000,000 shares of common stock, \$0.0001 par value per share and 10,000,000 shares of undesignated preferred stock, \$0.0001 par value per share.

SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
FOR THE YEARS ENDED DECEMBER 31, 2013, 2012 and 2011
(in thousands)

	Balance at Beginning of Period	Charged (Credited) to Income	Deductions and Other	Balance at End of Period
Allowance for Doubtful Accounts				
Year ended December 31, 2013	\$ 74	\$ 32	\$ (25)	(a) \$
Year ended December 31, 2012	\$ 47	\$ 70	\$ (43)	(a) \$
Year ended December 31, 2011	\$ 48	\$ 469	\$ (470)	(a) \$



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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2013. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2013, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of consolidated financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed our internal control over financial reporting as of December 31, 2013, the end of our fiscal year. Management based its assessment on criteria established in Internal Control-Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management’s assessment included evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment.

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles. We reviewed the results of management’s assessment with the Audit Committee of our Board of Directors.

Our independent registered public accounting firm, Grant Thornton LLP, independently assessed the effectiveness of the company’s internal control over financial reporting, as stated in their attestation report, which is included in Part II, Item 8 of this Form 10-K.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15 (d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting

Section 2

ADDITIONAL COMPANY AND INDUSTRY INFORMATION

ABC, Inc.

Recent Mortgage Industry Trends and Developments

The residential mortgage industry continues to evolve and undergo significant changes since 2007, largely in response to the hundreds of billions of dollars of loan defaults and massive losses suffered by lenders and investors. The losses incurred have led to three major trends that significantly impact the residential mortgage industry.

Increased Regulation Affecting Lenders and Investors

Many regulatory reforms have been introduced or proposed to ensure meaningful disclosures by lenders to borrowers, increased transparency and objectivity of settlement services and greater accountability of lenders and mortgage originators. Many of the significant changes in regulations were issued in final form in 2013 including material changes to:

- Regulation Z of the Truth in Lending Act of 1968, as amended, or TILA , by the Consumer Financial Protection Bureau, or CFPB , with an effective date for applications taken on or after January 10, 2014, in which the CFPB implemented amendments to TILA made by the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank Act , to require that creditors determine a consumer's ability to repay a mortgage before making a loan and to establish both minimum mortgage underwriting standards and standards for complying with the ability to repay requirement by defining a “qualified mortgage,” or QM.
- both Regulation X of the Real Estate Settlement Procedures Act of 1974 as amended, or RESPA, and Regulation Z of TILA , with an effective date for applications taken on or after January 10, 2014, in which the CFPB implemented amendments to RESPA and TILA made by the Dodd-Frank Act to expand the types of mortgage loans that are subject to the protections of the Home Ownership and Equity Protection Act of 1994, or HOEPA , by revising and expanding the triggers for coverage under HOEPA , and to impose additional restrictions on HOEPA mortgage loans, including a pre-loan counseling requirement.
- both Regulation X of RESPA and Regulation Z of TILA , with a future effective date for applications taken on or after August 1, 2015, in which the Dodd-Frank Act directs the CFPB to issue proposed rules and forms that combine certain disclosures that consumers receive in connection with applying for and closing on a mortgage loan. In addition to combining the existing disclosure requirements and implementing new requirements in the Dodd-Frank Act , the final rule provides extensive guidance regarding compliance with those requirements.

In addition to the regulatory reforms that have been introduced or proposed, other significant changes in regulations have been implemented since 2008 that are subject to regulatory enforcement including:

- implementation of the Secure and Fair Enforcement for Mortgage Licensing Act of 2008, as amended, or SAFE , designed to require licensing and tracking of mortgage originators;
- material changes to Regulation Z of TILA by the Federal Reserve Board to protect consumers in the mortgage market from unfair or abusive lending practices that could arise from certain loan originator compensation practices by prohibiting payments to loan originators based on the terms or conditions of the transaction other than the amount of credit extended.

These regulatory reforms further complicate the process and increase the amount of documentation required to originate and fund residential mortgages.

Increased Quality Standards Imposed by Regulators, Lenders and Investors

Lenders have eliminated many high-risk loan product offerings and have significantly tightened underwriting and processing requirements. Similarly, investors seek higher-quality, lower-risk loans in which to invest. Consistent with these tightened standards and expectations, lenders and investors are demanding increased levels of documentation of the data upon which a lending decision will be based, increased use of third- party services to obtain unbiased and independent verification of borrowers' creditworthiness, greater proof of the adequacy of the collateral securing mortgages and strict compliance with regulatory requirements. This trend further increases the amount of documentation and number of services required to originate and fund residential mortgages. Increased enforcement by federal and state regulators continues to encourage mortgage originators to explore technology solutions that provide adequate controls and policy enforcement to facilitate originating compliant loans.

Our Strategy

Our mission is to be the industry standard platform for residential mortgage origination in the United States. Key elements of our strategy include:

Increase the number of Awesome users.

Focus sales efforts on Awesome as Software-as-a-Service

(SaaS). Sell additional products and services to Awesome users .

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Products and Services

Awesome

Awesome is our proprietary comprehensive software solution that combines loan origination, business management and customer relationship management software for mortgage originators into one end- to- end system, and also provides seamless access to the investors, lenders and service providers on the ABC Network . Awesome helps users structure and streamline their mortgage origination process and facilitates collaboration among internal departments of a mortgage origination company. It supports efficiency in gathering, reviewing and verifying mortgage related data and in producing accurate

documentation. It also enables enforcement of rules and business practices designed to ensure loan quality, adherence to processing standards and regulatory compliance. The core architecture of Awesome utilizes a single database that is accessible to all participants throughout the mortgage origination process.

Mortgage originators can subscribe to Awesome, an on-demand solution that we host which the customer accesses through the Internet. Mortgage originators using SaaS Awesome pay monthly per-user subscription fees or fees based on their monthly loan volume, either separately or as a bundled package, subject to monthly base fees. This Success-Based Pricing model also includes our Awesome Docs Solution and Awesome Compliance Services.

Awesome Solutions and Services

Awesome CenterWise : Awesome CenterWise is a bundled offering of Awesome WebCenter and Awesome EDM.

Awesome Awesome Electronic Document

Awesome TPO Awesome Compliance Service Awesome Product and Pricing Service

Awesome Appraisal Awesome Flood Service. Documentation and data are stored automatically for review and investor delivery.

The ABC Network

A key component of SaaS Awesome is the ABC Network , which enables mortgage originators to choose from, and connect to, a broad array of investors, mega lenders and third party service providers essential to the processing and funding of loans.

Investors, mega lenders and service providers enter into contracts with us that allow their proprietary operating systems to inter-operate with the ABC Network . Lenders and service providers generally pay us fees on a per transaction basis when the mortgage originator orders these services through the ABC Network .

Technology

Our technology infrastructure supports all of our on-demand products and services.

Data Centers and Network Access

Our primary data centers are hosted by a leading SSAE-16 Type II certified provider of hosting services in Santa Clara, California and Chicago, Illinois. All applications provided by ABC will run actively in either of these two sites at any time. During 2012, we performed a complete refresh of our data centers and infrastructure to increase reliability, meet future scalability needs and support the product roadmap going forward. This effort has significantly increased overall systems capacity while adopting industry standard certified design which is independently audited for security and scalability.

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The data centers host all of the ABC Network services and SaaS versions of Awesome. The data centers are designed with fault tolerance protection for all layers of the platform and infrastructure, including routers, switches, load balancers and firewalls, as well as the web and application services and backend database connections. In the event of a complete site failure, such as may occur in the event of a regional natural disaster, all of the services in a site can be recovered to the other site as a part of our disaster recovery strategy.

Network Security

All data transmitted and processed within the ABC Network and to our customers is encrypted using industry standard Secure Sockets Layer (SSL) protocol to protect sensitive data against third-party disclosure in transit. Servers and network components are secured with access control mechanisms and protected by hardened industry standard firewalls, virus protection and intrusion prevention/detection systems. Security services are constantly monitored and updated in order to address emerging vulnerabilities. Even with our robust security monitoring and detection systems, we cannot guarantee that our security measures will prevent security breaches and we may need to expend significant resources to protect against and remedy any potential security breaches and their consequences. Threats and vulnerabilities to any network infrastructure are exposed continuously and there are often time lags before mitigations are deployed by our vendors.

Research and Development

We devote substantial resources to enhance the features and functionality of our offerings as well as developing new products and services.

Our research and development expenses totaled \$24.7 million, \$18.1 million and \$13.0 million in 2013 , 2012 and 2011 , respectively.

Intellectual Property

Our success depends in large part on our proprietary products and technology for which we seek protection from a combination of patent, copyright, trademark and trade secret laws and other agreements with employees and third parties. We require our officers, employees and consultants to enter into standard agreements containing provisions requiring confidentiality of proprietary information and assignment to us of all inventions made during the course of their employment or consulting relationship. We also enter into nondisclosure agreements with our commercial counterparties and limit access to, and distribution of, our confidential information.

We hold a number of registered and unregistered trademarks, service names and domain names that are used in our business in the United States.

Competition

The mortgage origination software market is highly competitive. There are many software providers catering to mortgage brokerages and mortgage lenders. Our current principal software competitors

include: Byte Software Inc., a subsidiary of CBCInnovis ; Calyx Technology, Inc. ; Davis + Henderson Corporation; Harland Financial Solutions, a subsidiary of Davis + Henderson Corporation ; ISGN Solutions Inc.; Mortgage Builder Software, Inc.; OpenClose Mortgage Software; and PCLender.com, Inc., a subsidiary of Fidelity National Financial, Inc. . Some of these software providers, including Calyx Technology, Inc., also provide connectivity between their software users and lenders and service providers.

Competition with Software Providers

We compete against software providers based on our ability to provide:

- a comprehensive software solution that provides all business-critical functions including customer acquisition, loan processing, task management, communication with borrowers and other mortgage origination participants, reporting, regulatory compliance and general business management;
- solutions that create efficiencies in gathering, reviewing and verifying mortgage related data and producing accurate documentation;
- on-demand solutions that reduce the need for IT infrastructure and overhead while providing the ability to update capabilities and adopt new regulations in a timely manner;
- customizable business rules to automate processes, promote accountability and enforce business practices that help assure loan quality and regulatory compliance;
- a single database to reduce data errors and facilitate collaboration among departments within a mortgage origination company and comprehensive monitoring of the business of the entire enterprise;
- attractive pricing options, such as our Success-Based Pricing model, allowing customers to time payments to cash flow;
- an integrated network to submit loan files electronically and securely to lenders and electronically order all of the services necessary to originate a loan; and
- security, reliability and data protection.
-

Competition Regarding the ABC Network

The ABC Network is only available to mortgage originators using Awesome. The principal competition to the use of the ABC Network remains traditional methods of exchanging data and documents among mortgage industry participants by email, facsimile, phone, courier and mail. In addition, competition comes from mortgage originators using a standalone web browser to go individually to each investor, lender, or service provider's website and then manually upload loan data or enter information into the website. Mortgage originators may continue to use these methods due to habit, personal business relationships or for other reasons, despite the disadvantages of duplicative efforts, time delays, errors and costs, redundant paper documentation and potential privacy and security breaches.

Lenders and service providers, including those who participate on the ABC Network , can and do connect with mortgage originators that are not Awesome users in a variety of ways, including through other

networks between mortgage originators and lenders and service providers such as RealEC Technologies, Inc., a subsidiary of Fidelity National Financial, Inc.

We compete with respect to the ABC Network based on offering mortgage originators accessibility to a critical mass of investors, lenders and service providers and enabling mortgage originators to transact all aspects of the mortgage origination process over the network. In addition, we compete with respect to the ABC Network by providing investors, lenders and service providers with greater access to the mortgage origination community, which enables them to increase their revenue opportunity and lower the cost of marketing and customer support.

We believe we generally compete favorably with our competitors; however, some of our actual and potential competitors enjoy substantial competitive advantages over us, such as longer operating histories and significantly greater financial, technical, marketing and other resources.

Government Regulation

The U.S. mortgage industry is heavily regulated. Mortgage originators, lenders, investors and service providers with which we do business are subject to federal, state and local laws that regulate and restrict the manner in which they operate in the residential mortgage industry, including Regulation X of RESPA, Regulation Z of TILA, the Mortgage Disclosure Improvement Act, and SAFE. In addition, the passage of the Dodd-Frank Act has increased, and will continue to increase, regulation of the mortgage industry, including: generally prohibiting lenders from making residential mortgage loans unless a good faith determination is made of a borrower's creditworthiness based on verified and documented information; requiring the CFPB to enact regulations to help assure that consumers are provided with timely and understandable information about residential mortgage loans that protect them against unfair, deceptive and abusive practices; and requiring federal regulators to establish minimum national underwriting guidelines for residential mortgages that lenders will be allowed to securitize and sell to third-party investors without retaining any of the loans' default risk. Although we are not directly subject to these laws and regulations, changes to these laws and regulations could broaden the scope of parties or activities subject to regulation and require us to comply with their restrictions, and new products and services developed by us may be subject to, or have to reflect, these laws or regulations.

In addition, we are subject to general business laws and regulations, as well as laws and regulations specifically governing the Internet, such as those covering taxation, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, broadband residential Internet access and the characteristics and quality of services.

Employees

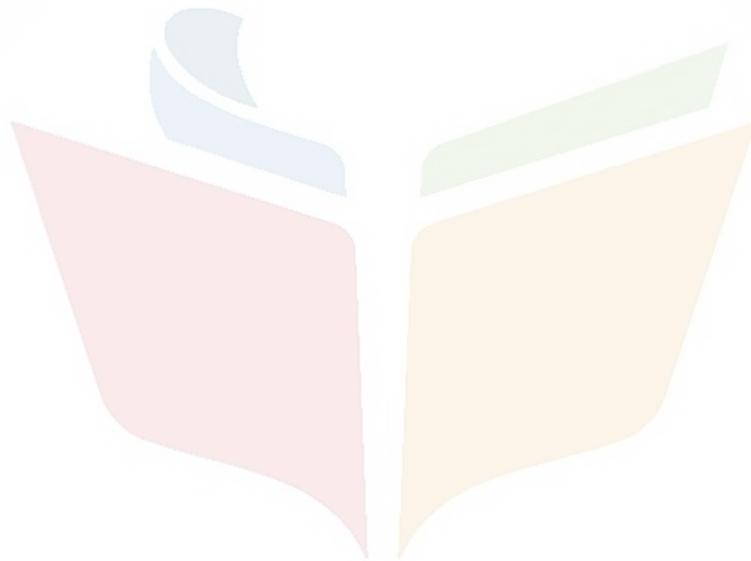
At December 31, 2013, we had 407 full-time employees, including 79 in sales and marketing, 275 in research and development and technology and 53 in general and administrative functions. None of our employees are covered by a collective bargaining agreement.

Facilities

Our corporate headquarters are located in California, in two facilities totaling 54,000 square-feet, under subleases expiring in May 2015. We also have field-based staff operating in several areas around the country, primarily based in California; Massachusetts; Nebraska; and New Jersey.

RISK FACTORS

You should carefully consider the risks described below and the other information in this report. If any of the following risks materialize, our business could be materially harmed, and our financial condition and results of operations could be materially and adversely affected. The risks described below are not the only ones facing us. Additional risks not currently known to us or that we currently believe are immaterial may also impair our business, results of operations, financial condition and liquidity.



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Our future performance will be highly dependent on our ability to continue to attract SaaS Awesome customers and to grow revenues from new on-demand services.

In order to grow our business, we must expand the use of settlement services on, and increase the number of transactions effected through, the ABC Network.

System interruptions that impair access to the ABC Network or SaaS Awesome could damage our reputation and brand and substantially harm our business.

Our failure to protect the confidential information of our Awesome users, our ABC Network participants and their respective customers could damage our reputation and brand and substantially harm our business.

We cannot accurately predict subscription renewal or upgrade rates and the impact these rates may have on our future revenues and operating results.

Mortgage lending volume was lower in 2013 than in 2012 , and it is expected to be lower in 2014 than in 2013 due to various factors which could adversely affect our business.

We expect a number of factors to cause our operating results to fluctuate on a quarterly and annual basis, which may make it difficult to predict our future performance.

Our revenues and operating results have in the past varied and could in the future vary significantly from quarter-to-quarter and year-to- year because of a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be indicative of future operating results. In addition to other risk factors discussed in this section, factors that may contribute to the variability of our quarterly and annual results include:

- the number of Awesome users;
- the volume of mortgages originated by Awesome users, especially users on our Success-Based Pricing model;
- transaction volume on the ABC Network ;
- fluctuations in mortgage lending volume;
- the relative mix of purchase and refinance volume handled by Awesome users;
- the level of demand for our services;
- the timing of the introduction and acceptance of ABC Network offerings and new on-demand services;
- costs associated with defending intellectual property infringement and other claims; and
- changes in government regulation affecting ABC Network participants or our business.

Due to these and other factors, our future results may not reach our internal projections. In addition, our operating results in future periods may not meet the expectations of investors or public market analysts who follow our company, which could cause our stock price to decline rapidly and significantly.

The results of any prior quarterly or annual periods should not be relied upon as indications of our future operating performance.

Since part of our sales efforts are targeted at larger customers, our sales cycle may become longer and more expensive, we may encounter pricing pressure and implementation and customization challenges, and we may have to delay revenue recognition for some complex transactions, all of which could harm our business and operating results.

Supporting our existing and growing customer base could strain our personnel resources, and if we are unable to scale our operations and increase productivity, we may not be able to successfully implement our business plan.

Continued growth may place significant demands on our management and our infrastructure and require significant expenditures and resources.

Integrating future acquisitions could disrupt our business, harm our financial condition and operating results or dilute or adversely affect the price of our common stock.

Events similar to the extreme turmoil in the residential mortgage industry that occurred from 2007 to 2009 could adversely affect our business.

The residential mortgage industry is heavily regulated and changes in current legislation or new legislation could adversely affect our business.

Potential structural changes in the U.S. residential mortgage industry, in particular plans to diminish the role of Fannie Mae and Freddie Mac, could disrupt the residential mortgage market and have a material adverse effect on our business.

We may be limited in the way in which we market our business or generate revenue by U.S. federal law prohibiting referral fees in real estate transactions, and if we are found to be in violation of such laws we would be subject to significant liability.

We depend on key and highly skilled personnel to operate our business, and if we are unable to retain our current or hire additional personnel, our ability to develop and successfully market our business could be harmed.

We operate in a highly competitive market, which could make it difficult for us to attract and retain Awesome users and ABC Network participants.

Failure to adapt to technological changes may render our technology obsolete or decrease the attractiveness of our solutions to our customers.

Failure to adequately protect our intellectual property could harm our business.

Assertions that we infringe third-party intellectual property rights could result in significant costs and substantially harm our business.

If we fail to maintain proper and effective internal controls, our ability to produce accurate financial statements could be impaired, which could result in a loss of investor confidence in our financial reports, significant expenses to remediate any internal control deficiencies and ultimately have an adverse effect on the market price of our common stock.

If one or more U.S. states or local jurisdictions successfully assert that we should have collected or in the future should collect additional sales or user- taxes on our fees, we could be subject to additional liability with respect to past or future sales, and the results of our operations could be adversely affected.

Our business is subject to the risks of earthquakes, fires, floods and other natural catastrophic events and to interruption by man-made problems such as terrorism.

Our stock price is volatile and purchasers of our common stock could incur substantial losses.

The trading price of our common stock may be subject to wide fluctuations in response to various factors, some of which are beyond our control. In addition to the factors discussed in this “Risk Factors” section and elsewhere in our filings with the Securities and Exchange Commission, these factors include:

- our operating performance and the operating performance of similar companies;
- the overall performance of the equity markets;
- the number of shares our common stock publicly owned and available for trading;
- threatened or actual litigation;
- changes in laws or regulations relating to our solutions;
- any major change in our board of directors or management;
- publication of research reports about us or our industry or positive or negative recommendations or withdrawal of research coverage by securities analysts;
- large volumes of sales of our shares of common stock by existing stockholders; and
- general political and economic conditions.

In addition, the stock market in general has experienced extreme price and volume fluctuations. Securities class action litigation has often been instituted against companies following periods of volatility in the overall market and in the market price of a company’s securities. This litigation, if instituted against us, could result in very substantial costs, divert our management’s attention and resources and harm our business.

If securities or industry analysts discontinue publishing research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.

Certain provisions in our charter documents and Delaware law could discourage takeover attempts and lead to management entrenchment.

Dividend Policy

We have never declared or paid, and do not anticipate declaring or paying, any cash dividends on our common stock. Any future determination as to the declaration and payment of dividends, if any, will be at the discretion of our board of directors and will depend on then existing conditions, including our financial condition, operating results, contractual restrictions, capital requirements, business prospects and other factors our board of directors may deem relevant.

Overview

ABC is a relatively new and growth oriented company. A comparison of ABC and industry ratios.

GROWTH RATES %	COMPANY	INDUSTRY
Sales (Qtr vs year ago qtr)	1.5	9.35
Net Income (YTD vs YTD)	NA	NA
Net Income (Qtr vs year ago qtr)	-59.5	-1.62
Sales (5-Year Annual Avg.)	30.79	4.68
Net Income (5-Year Annual Avg.)	NA	6.14
Dividends (5-Year Annual Avg.)	NA	17.58

The Company has an eight member Board of Directors. Members A, B and C are CEOs that have marketing backgrounds. Members D, E and F have engineering backgrounds and are high level management in other software companies. Member H is an academic with a PhD in Management.

Member C of the Board approached one of your firm's partners requesting that your firm audit the financial statements in preparation for their annual 10K SEC submission.

The ABC Network electronically connects the approximately 92,000 mortgage professionals using Awesome to the broad array of mortgage lenders, investors and third-party service providers integral to the origination and funding of residential mortgages. During the mortgage origination process, mortgage originators may order various services through the ABC Network, including credit reports, product eligibility and pricing services, automated underwriting services, appraisals, title reports, insurance, flood certifications and flood insurance, compliance reviews, fraud detection and document preparation.

Our revenues consist of on-demand and on-premise revenues. On-demand revenues are generated primarily from software subscriptions we host that customers access through the Internet, including customers who pay fees based on the number of loans they fund, or success basis, subject to monthly base fees, which we refer to as Success-Based Pricing . On-demand revenues also include software services that are sold transactionally as well as ABC Network transaction fees paid by lender-investors, service providers and certain government-sponsored entities participating on the ABC Network . On- premise revenues are generated from customer-hosted software licenses and implementations, training and maintenance services. For further discussion of the sources of our revenue and our revenue recognition policy, please see our Critical Accounting Policies and Estimates below.

Our on-demand revenues generally track the seasonality of the residential mortgage industry, typically, but not always, with increased activity in the second and third quarters and reduced activity in the first and fourth quarters as home buyers tend to purchase their homes during the spring and summer in order to move to a new home before the start of the school year. Mortgage volumes are also impacted by other factors such as interest rate fluctuations, home sale activity and general economic conditions, which can lead to departures from the typical seasonal pattern. For example, increases in mortgage interest rates could reduce the volume of new mortgages originated and, in particular, the volume of mortgage refinancings. We currently estimate that approximately 30% to 40% of our revenues has some sensitivity to volume . Contracted revenues, which are not sensitive to volume, represented 57% of total revenues for the year ended December 31, 2013.

We are investing aggressively in initiatives that we believe will help us continue to grow our business, improve our products and services and strengthen our competitive advantage while bringing sustainable, long-term value to our customers. During 2013, we accelerated our investments in our sales and client services capabilities, in research and development and in technology infrastructure to support our user additions and overall business growth. These investments included expanding our talent across the organization by hiring additional personnel, especially for our customer acquisition, client services and implementation teams and our research and development teams; developing next- generation products and enhancements; purchasing computer equipment; upgrading our telephony systems and building out new office facilities.

In addition to our internal initiatives, our business strategy has evolved to address recent industry trends, including:

- expected lower lending volume;
- increased quality standards imposed by regulators, lenders and investors;
- increased regulation affecting lenders and investors;
- greater focus by our customers on operational efficiencies; and
- customers adopting multi-channel strategies We are responding to these trends as follows:

Acquisition Strategy

Our industry is highly fragmented, and we believe there are strategic opportunities available to acquire competing software companies or software providers that offer related mortgage origination functionality that will complement and increase the attractiveness of Awesome . For example, in January 2014 , we acquired substantially all the assets of MortgageCEO ,

Basis of Presentation

General

Our consolidated financial statements include the accounts of ABC , Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated upon consolidation.

Revenue Recognition

We generate revenue primarily from transaction-based fees and fees for software and related services. Our software can be accessed either through a company-hosted subscription or a customer-hosted license. Accordingly, our revenues are now described as on-demand and on- premise revenues. Sales taxes assessed by governmental authorities are excluded from revenue.

On-demand Revenues

On-demand revenues are revenues generated from company-hosted software subscriptions that customers access through the Internet as well as revenues from a small number of customers that have opted to self-host a portion of the software but pay fees based on a per closed loan, or success, basis subject to monthly base fees, which we refer to as Success-Based Pricing. On-demand revenues are also comprised of software services sold transactionally and ABC Network transaction fees.

On-premise Revenues

On-premise revenues are revenues generated from maintenance services, sales of customer-hosted software licenses (except for customer- hosted Success-Based Pricing revenues, which are included in on-demand revenues described above), and professional services, which include consulting, implementation and training services.

Cost of Revenues and Operating

***Expenses* Cost of Revenues**

Our cost of revenues consists primarily of: salaries and benefits, including stock-based compensation; expenses for document preparation, income verification and compliance services; customer support; data centers; depreciation on computer equipment used in supporting the ABC Network , SaaS Awesome and Awesome CenterWise offerings; amortization of acquired intangible assets such as developed technology and trade names; professional services associated with implementation of our

software; and allocated facilities costs. We expect that our cost of revenues will continue to increase in absolute dollars as our revenues increase, as we make additional investments in our technology infrastructure and as we continue to hire additional personnel in our implementation and customer support departments to support new customers.

Other Income (Expense), Net

Other income (expense), net consists of interest income earned on investments, cash accounts and notes receivable, offset by investment discount amortization and imputed interest expense related to the DMD acquisition holdback payments (see Note 5 of the Notes to Consolidated Financial Statements) and interest expense paid on equipment and software leases.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements which are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We evaluate our estimates and assumptions on an ongoing basis. Our estimates are based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Our actual results could differ from these estimates.

We believe that the assumptions and estimates associated with revenue recognition, income taxes, stock-based compensation, goodwill and intangible assets, fair value of investments, deferred commissions and software and website development costs have the greatest potential impact on our consolidated financial statements. Therefore, we consider these to be our critical accounting policies and estimates. For further information on all of our significant accounting policies, please see Note 2 of the Notes to Consolidated Financial Statements

Goodwill and Other Intangible Assets

Goodwill and other intangible assets are stated at cost less accumulated amortization, as appropriate. Other intangible assets include developed technology, trade names and customer lists and contracts. Intangibles with finite lives are amortized on a straight-line basis over the estimated periods of benefit, generally one to nine years. Goodwill is not amortized, but tested for impairment at least annually, or whenever changes in circumstances indicated that the carrying amount of goodwill or intangible assets may not be recoverable. These tests are performed at the reporting unit level, which is the company as a whole, using a two-step, fair-value approach. We completed annual impairment tests for the years ended December 31, 2013, 2012 and 2011 and determined that our goodwill was not impaired for those years.

If management's estimates of future operating results change, if there are changes in identified reporting units or if there are changes to other significant assumptions, the estimated carrying values of any such reporting units and the estimated fair value of goodwill could change significantly, and could result in an

impairment charge. Such changes could also result in goodwill impairment charges in future periods, which could have a significant impact on our operating results and financial condition therein.

We assess the impairment of identifiable intangible assets whenever events or changes in circumstances indicate that an asset's carrying amount may not be recoverable. An impairment loss would be recognized when the sum of the undiscounted estimated future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. Such impairment loss would be measured as the difference between the carrying amount of the asset and its fair value. Cash flow assumptions are based on historical and forecasted revenue, operating costs and other relevant factors. If management's estimates of future operating results change, or if there are changes to other assumptions, the estimate of the fair value of our acquired product rights and other identifiable intangible assets could change significantly. Such change could result in impairment charges in future periods, which could have a significant impact on our operating results and financial condition.

Fair Value of Investments

All of our investments that have maturities of greater than 90 days are classified as available-for-sale and are carried at fair value. We invest excess cash primarily in investment-grade interest-bearing securities such as money market accounts, certificates of deposit, commercial paper, corporate bonds, municipal and government agency obligations and guaranteed obligations of the U.S. government, all of which are subject to minimal credit and market risks. Fair value is determined based on quoted market rates when observable or utilizing data points that are observable, such as quoted prices, interest rates and yield curves. The cost of available-for-sale marketable securities sold is based on the specific identification method. Unrealized gains and losses, net of tax, are reported in stockholders' equity as accumulated other comprehensive loss. Realized gains and losses are included in other income (expense), net. Interest and dividends are included in other income (expense), net when they are earned.

As of December 31, 2013, our assets measured and recorded at fair value on a recurring basis included \$16.4 million of money market funds and \$105.5 million of marketable debt instruments. Of these marketable debt instruments, \$11.4 million was classified as Level 1 and

\$94.1 million as Level 2. All of our money market funds are classified as Level 1. When determining fair value, we consider the principal or most advantageous market in which we would transact, and we consider assumptions that market participants would use when pricing the asset or liability. For further information, see "Fair Value of Financial Instruments" in Notes 2 and 4 of the Notes to Consolidated Financial Statements.

Credit risk is factored into the valuation of financial instruments that we measure and record at fair value. When fair value is determined using pricing models, such as a discounted cash flow model, the issuer's credit risk is factored into the calculation of the fair value, as appropriate.

Our money market funds and marketable debt instruments that are measured and recorded at fair value on a recurring basis and classified as Level 1 were classified as such due to the use of observable market

prices for identical securities that are traded in active markets . Management judgment was required to determine the levels for the frequency of transactions that should be met for a market to be considered active. Our assessment of an active market for our marketable debt instruments generally takes into consideration the number of days each individual instrument trades over a specified period.

When we use observable market prices for identical securities that are traded in less active markets, we classify our marketable financial instruments as Level 2. When observable market prices for identical securities are not available, we price our marketable financial instruments using non-binding market consensus prices that are corroborated with observable market data; quoted market prices for similar instruments; or pricing models with all significant inputs derived from or corroborated with observable market data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs and, to a lesser degree, unobservable market inputs. We corroborate non-binding market consensus prices with observable market data as such data exists.

We had no investments classified as Level 3 at December 31, 2013.

Deferred Commissions

Deferred commission expenses are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to our direct sales force. Commissions are calculated based on a percentage of the revenues for the non-cancelable term of subscription contracts, which are typically one to five years .

Prior to 2013, commissions were paid and recognized as sales expense when customer payments for contracted services were received on a monthly basis because commissions were earned based on receipt of customer payments. In 2013, we amended our commission plans to provide for payment after the customer's contract is signed. As a result of the change in commission plans, beginning in 2013, commission expense is deferred and amortized to sales expense over the non-cancelable terms of the related subscription contracts. The deferred commission expense amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. The new plans also include claw back provisions, which require repayment of a proportionate amount of commissions, should customers cancel their contracts prior to the end of the initial contractual term.

Software and Website Development Costs

The Company capitalizes internal and external costs incurred to develop internal-use software and website applications. Capitalized internal costs include salaries, benefits and stock-based compensation charges for employees that are directly involved in developing the software or website application, and depreciation of assets used in the development process. Capitalized external costs include third-party consultants involved in the development process, as well as other direct costs incurred as part of the development process.

Capitalization of costs begins when the preliminary project stage is completed, and management authorizes and commits to funding a project and it is probable that the project will be completed and the software or website application will be used to perform the function intended. Internal and external costs incurred as part of the preliminary project stage are expensed as incurred.

Capitalization ceases at the point at which the project is substantially complete and ready for its intended use, after all substantial testing is completed. Internal and external training costs and maintenance costs during the post-implementation operation stage are expensed as incurred.

Internal-use software is amortized on a straight-line basis over its estimated useful life, generally three years. Our management evaluates the useful lives of these assets on an annual basis and tests for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets. The capitalized costs are included in the property and equipment, net line in the accompanying consolidated balance sheets. For the years ended December 31, 2013 and 2012, we capitalized software and website application development costs of \$5.0 million and \$0.5 million, respectively. There were no such costs capitalized in the year ended December 31, 2011. There was \$69,000 in amortization of capitalized internal-use software and website development costs recorded during the year ended December 31, 2013 and no such amortization recorded during the years ended December 31, 2012 and 2011.

On-demand revenues increased by \$27.2 million, consisting primarily of a \$25.8 million increase in SaaS Awesome revenues, of which

\$24.2 million related to our Success-Based Pricing model. SaaS Awesome revenues increased as a result of the addition of new SaaS Awesome users and as a result of upgrades of existing customers to our SaaS platform. The number of average active SaaS Awesome users increased by 66.9% from 33,203 for the year ended December 31, 2012 to 55,421 for the year ended December 31, 2013 due to the addition of new customers and the transition of on-premise licensed users to our SaaS Awesome Success-Based Pricing offering. The revenue growth attributable to the increase in average active SaaS Awesome users was partially offset by a 7.9% decrease in SaaS Awesome revenue per average active SaaS user from \$1,444 for the year ended December 31, 2012 to \$1,330 for year ended December 31, 2013, caused primarily by a decline in closed loan volume, lenders' focus on preparing for ATR / QM rules and longer implementation cycles for some of the larger customers that were added earlier in 2013.

Additional contributors to the growth in on-demand revenues were a \$1.0 million increase in revenues from our Awesome CenterWise offering primarily due to an increase in our customers, a \$2.5 million increase in revenues from our TQL program and a \$0.3 million increase in revenues from network transactions due to increased network usage for the year ended December 31, 2013 compared to the same period of 2012. Partially offsetting the increase in on-demand revenues was a \$2.9 million decrease in revenues from our standalone Awesome Docs Solution for the year ended December 31, 2013 compared to the same period of 2012, primarily as a result of the conversion of customers from standalone solutions to SaaS Awesome and partially from two standalone solutions subscription customers having gone out of business during the third quarter of 2013.

On-premise revenues decreased by \$0.6 million for the year ended December 31, 2013 compared to the same period of 2012, primarily due to a \$2.7 million decrease in software license and maintenance fees as our on-premise customers converted to SaaS Awesome Success-Based Pricing users. This decrease in revenues was offset by a \$2.2 million increase in revenues from implementation services for the year ended December 31, 2013 compared to the same period of 2012, as we began to charge for implementation services during the third quarter of 2013.

Total revenues increased \$46.4 million, or 83.5%, for the year ended December 31, 2012 as compared to the same period of 2011.

On-demand revenues increased by \$41.9 million, consisting primarily of a \$27.7 million increase in SaaS Awesome revenue resulting from the addition of new SaaS Awesome users and upgrades of existing customers to our SaaS platform resulting from our continued marketing focus on our Success-Based Pricing model as well as an increase in mortgage origination volume. The number of active SaaS Awesome users increased by 70.9% to 41,458 users at December 31, 2012 from 24,252 users at December 31, 2011 due to the addition of new customers as well as the transition of on-premise licensed users to our SaaS Awesome Success-Based Pricing offering. SaaS Awesome Revenue per average active SaaS user increased by 41.0% for the year ended December 31, 2012 compared to same period of 2011 due to an increase in the number of closed loans per Active SaaS User as well as the continued movement of users to our Success-Based Pricing model, which offers higher revenue per user compared to our traditional license model.

On-demand revenues also increased due to continued adoption of new product offerings. Revenues from our tax transcript services that we began offering in the first quarter of 2011 increased by \$2.3 million while our appraisal and title services increased by \$1.2 million for the year ended December 31, 2012 compared to same period of 2011. Our TQL program was introduced during the fourth quarter of 2011 and TQL revenues increased by \$1.4 million for the year ended December 31, 2012 compared to the year ended December 31, 2011.

Other on-demand revenues increased due to a \$4.0 million increase in vendor transaction revenues due to increased network usage and a greater number of users, a \$2.1 million increase in compliance services due to increased usage by our customers as well as a greater number of users, a \$2.0 million increase in document preparation revenues and a \$1.2 million increase in other on-demand and transaction revenues.

Gross profit increased by \$17.0 million and gross margin decreased by 2.8 percentage points during the year ended December 31, 2013 as compared to the same period of 2012 as revenues increased by \$26.6 million and cost of revenues increased by \$9.6 million. The decrease in the gross margin for 2013 is primarily a result of an increase in fixed costs associated with headcount added to our implementation, professional services and customer support organizations and investments we have made in expanding our data centers. Cost of revenues increased primarily due to a \$1.2 million increase in third-party royalty expenses to support the increased revenues, a \$5.8 million increase in salaries and employee benefits from increased professional services and customer support headcount, a \$0.5 million increase in stock-

based compensation expense relating to our increased headcount, a \$0.5 million increase in temporary staff and consulting costs associated with improvements to our data center operations and a \$1.2 million increase in depreciation expense due to capital additions.

Gross profit and gross margin increased by \$39.0 million and 5.7 percentage points, respectively, in the year ended December 31, 2012 as compared to the same period of 2011 as revenues increased by \$46.4 million and cost of revenues increased by \$7.3 million. The increase in the gross margin for 2012 is primarily a result of our ability to utilize existing infrastructure to accommodate revenue growth and the fixed nature of certain costs such as intangible amortization. Cost of revenues increased primarily due to a \$2.6 million increase in third-party royalty expenses to support the increased revenues, a \$2.6 million increase in salaries and employee benefits from increased professional services and customer support headcount as well as the increase in headcount in hiring former DMD employees following the DMD acquisition in August 2011, a \$1.0 million increase in consulting costs associated with improvements to our data center operations and a \$0.9 million increase in depreciation expense due to property and equipment additions. The increase in cost of revenues was partially offset by the capitalization of \$1.0 million in compensation and consulting costs associated with data center improvements.

Sales and marketing expenses increased by \$3.4 million, or 19.3%, in the year ended December 31, 2013 as compared to the same period of 2012. This increase was primarily due to a \$1.9 million increase in salaries and employee benefits as well as a \$0.6 million increase in stock-based compensation expense, both reflecting an increase in headcount as we continued to grow our sales and marketing departments in an effort to increase our market share. Additionally, travel and entertainment expenses in support of our sales function increased by \$0.5 million, and technology and telecommunications expenses incurred in support of our sales function increased by \$0.3 million.

Sales and marketing expenses increased by \$5.8 million, or 47.5%, in the year ended December 31, 2012 as compared to the same period of 2011. This increase was primarily due to a \$2.2 million increase in salaries and employee benefits reflecting additional headcount as we have grown our sales department in order to address anticipated demand for our software solutions and additional headcount from the hiring of former DMD employees in August 2011, a \$1.2 million increase in commissions commensurate with the increase in revenues, a \$0.8 million increase due to the increased level of sales and marketing activities in 2012 as compared to the prior-year period including our Awesome User Summit in the fourth quarter of 2012 and a \$0.6 million increase in amortization of acquired intangible assets related to the acquisition which occurred in August 2011.

Research and development expenses increased by \$6.6 million, or 36.8%, in the year ended December 31, 2013 compared to the same period of 2012. The increase was primarily due to a \$3.8 million increase in salaries and employee benefits reflecting an increase in headcount, a \$1.9 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and stock option and RSU grants made to new and existing employees and a \$0.5 million increase in the use of consultants.

Research and development expenses increased by \$5.1 million, or 39.1%, in the year ended December 31, 2012 compared to the same period of 2011. The increase was primarily due to a \$2.8 million increase in salaries and employee benefits reflecting an increase in headcount which included the hiring of former DMD employees in August 2011, a \$1.1 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 as well as stock option grants made to new employees and a \$0.6 million increase in the use of consultants.

General and administrative expenses increased by \$9.3 million, or 42.8%, in the year ended December 31, 2013 as compared to the same period of 2012. This increase was primarily due to a \$4.4 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and stock option and RSU grants made to new and existing employees, a \$1.4 million increase in the use of consultants and temporary contractors for infrastructure and compliance projects, a \$1.1 million increase in technology expenses relating to licenses and support for software used to manage our business, a \$0.9 million increase in fees to professional service firms for accounting, tax, and investor relations services and a \$0.4 million increase in depreciation expenses resulting from overall growth of our business and headcount.

General and administrative expenses increased by \$8.7 million, or 67.4%, in the year ended December 31, 2012 as compared to the same period of 2011. This increase was primarily due to a \$3.6 million increase in stock-based compensation expense primarily resulting from Performance Awards granted to certain executives during the third quarter of 2012 as well as stock option grants made to new employees, a \$1.3 million increase in salaries and other employee benefits due to an increase in headcount, which included the hiring of former DMD employees, a \$1.4 million increase in bonus expense due to a greater number of employees eligible for bonus pay as well as improved operating performance of the Company, a \$1.1 million increase in hardware and software expenses associated with infrastructure upgrades, a \$0.6 million increase in the use of consultants and temporary workers, a \$0.3 million increase in credit card processing fees resulting from higher sales volumes and a \$0.2 million increase in depreciation expense due to recent increases in capital expenditures. The increases were offset by a \$0.5 million decrease in legal fees due to decreased usage of outside legal services and a \$0.4 million decrease in bad debt expenses resulting from the shift in the mix of our customer base from mortgage brokerages to mortgage lenders and improvement in the economy.

Other (Expense) Income, Net

Other income (expense), net includes imputed interest expense related to the DMD acquisition holdback liability and interest income from notes receivable and investments. The amounts were not significant in the years ended December 31, 2013, 2012 and 2011.

Liquidity and Capital Resources

As of December 31, 2013, we had cash, cash equivalents and short-term investments of \$79.8 million and long-term investments of \$56.3 million. Cash and cash equivalents consist of cash and money market accounts. Both short and long-term investments consist of corporate bonds and obligations, certificates of deposit, municipal obligations, U.S. government notes and U.S. government agency securities.

We believe that our existing cash, cash equivalents and short-term investments will be sufficient to fund capital expenditures, operating expenses and other cash requirements for at least the next 12 months. We may enter into acquisitions in the future, which could require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Cash provided by operating activities increased by \$1.5 million from \$27.8 million in 2012 to \$29.2 million in 2013. In the consolidated statements of cash flows, cash provided by operating activities is presented as net income adjusted for non-cash expense items and changes in operating assets and liabilities. Net income decreased by \$6.9 million for the year ended December 31, 2013 as compared to the same period of 2012. The net contribution of non-cash expense items to cash provided by operating activities increased by \$3.3 million for the year ended December 31, 2013 as compared to the same period of 2012. The net contribution of changes in operating assets and liabilities to cash provided by operating activities increased by \$5.1 million for the year ended December 31, 2013 as compared to the same period of 2012.

Contributing to the increase in the net contribution of non-cash expense items was a \$7.4 million increase in stock-based compensation expense, primarily due to Performance Awards granted to certain executives during the third quarter of 2012 and the first quarter of 2013 and new stock option and RSUs grants made to new and existing employees, offset in part by reductions from fully vested, fully amortized stock options, which no longer impacted expense in 2013. Also contributing was a \$1.7 million in depreciation expense, primarily due to purchases of property and equipment for our data centers and for our new ERP system, which was placed into service during the fourth quarter of 2013.

Additionally, amortization of investment premium increased by \$1.6 million due to purchases of short-term and long-term investments starting in the fourth quarter of 2012. Offsetting these contributors to cash provided by operating activities were excess tax benefits, which reduce cash provided by operating activities and increased by \$4.7 million primarily as a result of windfall tax benefits on the exercise of stock options, of which there were none in 2012. Also reducing cash provided by operating activities was the benefit from deferred income taxes, which increased by \$2.4 million, primarily due to increases to deferred taxes related to stock-based compensation, and the lack of a reduction in the deferred tax asset valuation allowance during 2013, as there was in 2012.

Changes in operating assets and liabilities resulted in a net increase of \$5.1 million to cash provided by operating activities in the year ended December 31, 2013 as compared to the same period in 2012. Our net accounts receivable balance fluctuates from period to period, depending on the timing of sales and billing activity, cash collections and changes to our allowance for doubtful accounts. The change in

prepaid expenses and other current assets was primarily due to the timing of the payment for computer software licenses, as well as an increase in taxes receivable resulting from windfall tax benefits on the exercise of stock options. The change in deposits and other assets was due to deferred commission expenses which started in 2013 and timing of the payment for software licenses. The change in accounts payable and accrued and other liabilities was due to the timing of additional liabilities and payments in general, and does not reflect any significant change in the nature of accrued liabilities.

Cash provided by operating activities increased by \$21.4 million from \$6.4 million in 2011 to \$27.8 million in 2012. This increase was primarily due to an increase of net income of \$15.8 million for the year ended December 31, 2012 as compared to the same period of 2011. Additionally, stock-based compensation expense increased by \$5.2 million for the year ended December 31, 2012 as compared to the same period of 2011. This increase resulted from new grants and the increased market price per share of our common stock, offset in part by reductions from fully vested, fully amortized stock options. Additionally, the change in deferred tax assets and liabilities increased by \$1.1 million, primarily due to the reduction in our deferred tax asset valuation allowance. Depreciation expense increased by \$1.2 million primarily due to purchases of property and equipment for our data center and amortization of other intangible assets increased by \$0.7 million primarily due to the acquisition of DMD. The increases were also offset by the increase in the excess tax benefit from exercise of stock options of \$2.0 million as well as the decrease in the provision for uncollectible accounts receivable of \$0.4 million.

Cash provided by operating activities is also affected by changes in operating assets and liabilities, which resulted in a net decrease of \$0.4 million to operating cash flows in the year ended December 31, 2012 as compared to the same period in 2011. Our net accounts receivable balance fluctuates from period to period, depending on the timing of sales and billing activity, cash collections and changes to our allowance for doubtful accounts. The change in prepaid expenses was due to the timing of the payment for insurance renewals, computer software licenses and computer equipment maintenance contracts as well as payments for prepaid maintenance related to computer hardware purchased for our data centers. The change in accounts payable and accrued and other liabilities was due to the timing of additional liabilities and specifically, to the payment of bonuses to employees prior to December 31, 2012.

Investing Activities

Our primary investing activities have consisted of purchases of investments, purchases of property and equipment specifically related to the build out of our data centers, as well as payments for acquisitions. Purchases of property and equipment may vary from period to period due to the timing of the expansion of our operations and certain software development projects subject to capitalization. We plan to continue to invest in technology hardware and software to support our growth and corporate infrastructure. Additionally, consistent with our acquisition strategy, we intend to continue pursuing additional strategic acquisitions.

Cash used in investing activities of \$52.3 million for the year ended December 31, 2013 was primarily the result of \$44.2 million in net purchases of investments, \$6.1 million for purchases of property and

equipment mainly for our data centers and a \$3.0 million holdback payment relating to the acquisition of DMD . This was partially offset by collections of \$1.0 million on an outstanding note receivable.

Cash used in investing activities of \$69.1 million for the year ended December 31, 2012 was primarily the result of \$58.1 million in net purchases of investments, \$8.1 million for purchases of property and equipment mainly for our data centers and a \$2.9 million holdback payment relating to the acquisition of DMD.

Cash used in investing activities of \$21.3 million for the year ended December 31, 2011 was primarily the result of \$18.2 million in cash payments related to the acquisitions of DMD and MPS as well as purchases of property and equipment of \$3.7 million primarily related to computer equipment and software to support the growth of our business.

Financing Activities

Financing activities have consisted primarily of proceeds from our public offerings of common stock in 2011 and 2012, net of offering costs. Additional cash has been provided from the exercise of stock options as well as from the effect of excess tax benefits from exercises of stock options.

Cash provided by financing activities of \$12.4 million for the year ended December 31, 2013 consisted primarily of \$6.5 million in proceeds from the exercise of stock options and \$6.7 million in excess tax benefit from exercise of stock options.

Cash provided by financing activities of \$61.8 million for the year ended December 31, 2012 consisted primarily of \$55.5 million in proceeds from our follow-on public offering, net of offering costs, \$4.3 million in proceeds from the exercise of stock options and \$2.0 million in excess tax benefit from exercise of stock options.

Cash provided by financing activities of \$24.3 million for the year ended December 31, 2011 consisted primarily of \$23.1 million in proceeds from our initial public offering, net of offering costs, and \$1.3 million in proceeds from the exercise of stock options.

Contractual Obligations

As of December 31, 2013, our contractual payment obligations are as follows:

Purchase obligations are associated with agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum services to be used; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Obligations under contracts that we can cancel without a significant penalty are not included in the table above. See Note 8 of the Notes to Consolidated Financial Statements.

Section 3

GENERAL RISK MANAGEMENT QUESTIONNAIRE

Required: Complete the questionnaire. Some questions have been pre-answered. They are marked as underlined and in italics. Assume you are the staff auditor and complete the questionnaire. Evaluate Risk Assessment for ABC as, low, moderate or high. Provide justification for your answer. You will need to review ABC's financial statements, notes to the statements and other information provided.

Your justification should be divided into the following categories. You should label each category and make your answers brief and concise.

External Factors

Industry Economic and Financial Conditions Uses
and Users of Financial Statements

Internal Factors

Management's Integrity Entity
Organization Financial Condition
of Entity Nature of Transactions

General Risk Management Questionnaire

EXTERNAL FACTORS

General Economic and Financial Conditions

Industry Economic and Financial Conditions

1. Are the products of this industry subject to rapid obsolescence? Y N Unknown 2. Is the industry highly competitive? Y N Unknown
3. Have there been an unusual number of bankruptcies in this industry? Y N Unknown
4. Does the estimated income for the year deviate significantly from the industry? Y N Unknown
5. Did the industry experience a strike or other labor unrest? Y N Unknown

Uses and Users of Financial Statements

1. Will the financial statements be filed with the Securities and Exchange Commission? YN
Unknown
2. Will the financial statements be submitted to the client's bank? Y N Unknown
3. Will the financial statements be submitted to credit agencies? YN Unknown
4. Will the financial statements be submitted to stockholders? Y N Unknown
5. Will the financial statements be submitted to employees with reference to:
 - Profit-sharing plans? Y N Unknown
 - Pension plans? Y N Unknown
 - Bonus arrangements? Y N Unknown
 - Other compensation arrangements? Y N Unknown
6. Will the financial statements be used in connection with negotiations relating to an acquisition or a disposal of a business or a segment of a business? YN Unknown
7. Will the financial statements be used in connection with negotiations for:
 - A loan? Y N Unknown
 - Private sale of stock? Y N Unknown
8. Are there other uses or users of these financial statements which may affect our risk? Y N
Unknown If so, list.

INTERNAL FACTORS

Management's Integrity

1. Are there any indications that management may lack integrity? Y N Unknown 2. Does management desire favorable earnings because of the following:
 - Need to meet forecasts? Y N Unknown
 - Need to support price of the entity's stock? Y N Unknown
 - Existence of management profit-sharing agreements? Y N Unknown

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3. Does management desire low earnings to reduce income taxes? Y NUnknown
4. Is management dominated by one or a few individuals? Y N Unknown
5. Does management have a poor reputation in the industry? Y NUnknown
6. Does management have a reputation for taking unusual or unnecessary risks? Y N
Unknown
7. Has there been considerable turnover in senior management positions? YNUnknown
8. Are there other characteristics of management personnel that may affect our risk? Y N
Unknown If so, list.

Entity Organization

1. Does the entity lack an audit committee? Y NUnknown
2. Does the entity fail to document its accounting system? Y N Unknown
3. Does the entity fail to use internal auditors? Y NUnknown
4. Do internal auditors, if any, not report to the audit committee or some other high organizational level of the entity? YN Unknown
5. Is the organization owner- or manager-dominated? Y NUnknown
6. Does the entity fail to document job requirements? Y NUnknown
7. Does management lack an understanding of accounting and administrative controls? Y NUnknown
8. Does management fail to implement accounting and administrative controls? Y N
Unknown
9. Has management failed to correct material weaknesses in internal accounting control that can be corrected? Y N Unknown
10. Are the entity's records generated to a significant degree by an EDP system? YN
Unknown

11. Does the entity fail to maintain perpetual records of:

- Inventories? Y NUnknown
- Long-lived assets? Y NUnknown
- Investments? Y NUnknown

12. If the entity maintains perpetual records, does it periodically compare them with physical counts? Y N Unknown

13. Does management fail to communicate to other personnel a commitment to control? Y N Unknown

14. Does the entity fail to maintain policy and procedures manuals? Y N Unknown

15. Is there a high turnover of accounting and finance personnel? Y N Unknown

16. Has the client recently changed auditors or attorneys? Y NUnknown

17. Does a hostile relationship exist between our staff and management? Y N Unknown

18. Has the client recently organized or acquired a subsidiary? Y N Unknown

Financial Condition of Entity

1. Does the entity have insufficient working capital? Y N Unknown

2. Does the entity have sufficient lines of credit? Y N Unknown

3. Does the entity depend on relatively few customers? Y N Unknown

4. Does the entity depend on relatively few suppliers? Y N Unknown

5. Are there violations of debt covenants? Y NUnknown

6. Has the entity recently experienced a significant period of losses? Y N Unknown

7. Is the entity using short-term obligations to finance long-term projects? Y N Unknown

8. Does the entity have excess productive capacity? Y N Unknown

9. Does the entity have high fixed costs? Y N Unknown

10. Has the entity experienced rapid expansion? Y N Unknown
11. Does the entity have a significantly long operating cycle? Y N Unknown
12. Does the entity have significant contingent liabilities? Y N Unknown
13. Is the entity the defendant in any significant litigation? Y N Unknown
14. Do major valuation problems exist, such as:
- Allowance for doubtful accounts? Y N Unknown
 - Inventories? Y N Unknown
 - Investments? Y N Unknown
 - Long-term construction contracts? Y N Unknown
15. Has the client experienced severe losses from investments or joint ventures? Y N
Unknown

Nature of Transactions

1. Does the entity engage in a significant number of consignment purchases or sales? Y N
Unknown
2. Does the entity engage in significant cash transactions? Y N Unknown
3. Does the entity engage in significant related-party transactions? Y N Unknown
4. Has the entity engaged in significant unusual transactions during the year or near the end of the year? Y N Unknown
5. Are there any questions on the timing of revenue recognition? Y N Unknown

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Section 4

CONTROL ENVIRONMENT QUESTIONNAIRE & PROBLEM

Tests of control can be grouped into:

Enquiry and confirmation. For example, ask the credit controller about the way in which customers are encouraged to pay and ask how these customers are identified and how often they are followed up. This is a relatively weak source of evidence because the credit controller might exaggerate his or her efforts.

Inspection. For example, the credit references or notes made by the credit controller of conversations.

Observation. For example, observing the credit controller at work.

Recalculation and reperformance. For example, ensuring that the aged receivables analysis seems to be accurate.

Question	Yes	No	N/A Unk	Tests
<i>INTEGRITY AND ETHICAL VALUES</i>				
1. Have appropriate entity policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct been established and are they adequately communicated?	X			
2. Does management demonstrate the appropriate “tone at the top”, including explicit moral guidance about what is right and wrong and is this communicated in both words and deeds?	X			
3. Are everyday dealings with employees, suppliers, citizens, bondholders, students, and auditors based on honesty and fairness?	X			
4. Are appropriate remedial actions taken in response to departures from approved policies and procedures or the code of conduct, and are the actions communicated or otherwise made known throughout the company?			X	
5. Are management overrides of established controls appropriately documented and explained and are deviations from such controls investigated?			X	
6. Is management under pressure to meet unrealistic performance goals particularly for short term results?	X			

7. Does previous experience with the entity indicate sufficient integrity on the part of entity personnel?	X
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Question	Yes	No	N/A Unk	<u>Tests</u>
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COMMITMENT TO COMPETENCE

(answered by the controller)

1. Have employee job descriptions, including specific duties, reporting responsibilities, and constraints been clearly established and effectively communicated to employees?	X			
2. Has management determined to an adequate extent the knowledge and skills needed to perform a particular job and is this information used in the hiring process?			X	
3. Does it appear that management, accounting, and information technology personnel are sufficiently competent to perform their assigned responsibilities?	X			
4. Does the department adequately compensate employees in order to attract qualified individuals?	X			
5. Are there clear criteria for hiring and promoting?			X	
6. Have employee performance evaluation techniques been implemented to identify incompetent or ineffective employees?			X	

GOVERNING BOARD OR AUDIT COMMITTEE

(answered by the CEO)

	Yes	NO	N/A or Unk	Tests
1. Does the company have a governing board or audit committee that is appropriate for the size and nature of the entity?	X			
2. Are members of the governing board or audit committee independent from the company's management?	X			
3. Do governing board or audit committee members have sufficient knowledge, industry experience, and time to serve effectively?	X			

Question	Yes	No	N/A or Unk	<u>Tests</u>
4. Does governing board composition provide sufficiently broad experience in legal, financial, and other functional areas important to the company operations (governing boards that lack expertise in a particular area can compensate by engaging consultants)?	X			
5. Does the governing board constructively challenge management's planned decisions (e.g., strategic initiatives and major transactions) and probe for explanations of past results (e.g., budget variances)?	X			
6. Does the governing board or audit committee meet regularly to set policies and objectives, review the entity's performance, and take appropriate actions, and are minutes of such meetings prepared and signed on a timely basis?	X			
7. Do members of the governing board or audit committee regularly receive the information they need to monitor management's objectives and strategies?	X			
8. Does the governing board or audit committee review the scope and activities of the internal and external auditors?	X			
9. Does the governing board or audit committee meet privately with the chief financial/ and or accounting officers, internal auditors, and external auditors to discuss the reasonableness of the financial reporting process, the system of internal control, significant comments or recommendations, and management's performance?			X	
10. Does the governing board take steps to ensure an appropriate "tone at the top"?			X	
11. Does the governing board or audit committee take action (e.g., issue directives to management) as a result of its findings?	X			

Question	Yes	No	N/A or	<u>Tests</u>
MANAGEMENT'S PHILOSOPHY AND OPERATING STYLE (answered by the CEO)				
1. Has a significant or unexpected change in management recently occurred or are such changes likely to occur during the next year?	X			
2. Has there been excessive turnover of management or supervisory personnel?		X		
3. Are management and operating decisions dominated by one or a few individuals?		X		
4. Does management move carefully, proceeding only after carefully analyzing the risks and potential benefits of a venture? (A high risk venture for government might include undertaking new programs prior to approval of funding sources, using riskier investment types, issuing significant amounts of debt that approach or exceed the legal debt limit, etc.)	X			
5. Does management set companywide objectives that include broad statements of what the entity desires to achieve that are supported by related strategic plans?	X			
6. Does management have mechanisms to anticipate, identify and react to events or activities that affect achieving company objectives?	X			
7. Is there reason to be concerned about management's overall commitment to accurate financial reporting?		X		
a. Does the company use controversial accounting policies?	X			
b. Does management tend to interpret accounting and reporting standards aggressively?	X			

Question	Yes	No	N/A or	<u>Tests</u>
c. Has management been reluctant to adjust the financial statements for material misstatements?		X		
d. Has management failed to adequately consult with the external auditors on accounting issues?		X		
8. Is there reason to be concerned about management's commitment to designing and maintaining reliable accounting systems or effective internal control?		X		
a. Does management appear unconcerned about maintaining effective internal control to permit the preparation of reliable financial statements and federal reports?		X		
b. Does management appear unconcerned about maintaining accountability and safeguarding funds, property, and other assets against loss from unauthorized use or disposition?		X		
c. Has management's responsiveness to prior audit findings, control recommendations, and questioned costs been negative?		X		
d. Has the company failed to establish procedures relative to the prevention of illegal acts, including the use of directives?		X		
e. Does the accounting or information technology department appear to be inadequately staffed?		X		
f. Do resources to assist personnel to perform their duties appear to be unavailable or inadequate?		X		
Question	Yes	No	N/A or Unk	<u>Tests</u>
ORGANIZATIONAL STRUCTURE (answered by the CEO)				
1. Is the organization of the company clearly defined in terms of lines of authority and responsibility?	X			

2. Are controls for authorization of transactions established at an adequately high level?	X			
3. Are such controls adequately adhered to?	X			
4. Is there adequate supervision and monitoring of decentralized operations?	X			
5. Is the organizational structure appropriate for the size and complexity of the entity?	X			
6. Has management established policies for developing and modifying accounting systems and control activities?	X			
7. Is management actively involved in supervising the accounting and information technology departments?	X			
8. Is there sufficient communication between management of the accounting and information technology departments?	X			
9. Are accounting and information technology departments centralized?	X			
10. Is there sufficient supervision and monitoring of information technology operations, especially decentralized information technology operations?	X			
Question	Yes	No	N/A or unk	<u>Tests</u>
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<i>ASSIGNMENT OF AUTHORITY AND RESPONSIBILITY</i> (answered by the CEO)				
1. Is there a clear assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements?	X			
2. Are employee job responsibilities, including specific duties, reporting relationships, and constraints clearly established and communicated to employees?	X			
3. Has management clearly communicated the scope of authority and responsibility to information technology and accounting personnel?	X			

4. Does the level of communication between the managers of the accounting and information technology departments appear to be sufficient?	X			
5. Is the documentation of information technology policies and procedures adequate?	X			
	Yes	No	N/A	Tests
<i>HUMAN RESOURCE POLICIES AND PRACTICES</i> (answered by the Manager of Human Resources)			or Un k	
1. Do personnel, including key managers, possess adequate knowledge and experience to discharge their responsibilities?	X			
2. Do company/departmental personnel understand the duties and procedures applicable to their jobs?	X			
3. Is the turnover of key personnel relatively low?		X		
4. Does the workload of departmental personnel appear to permit them to be mindful of controlling the quality of their work?	X			
5. Does previous experience with the department indicate sufficient competence on the part of departmental personnel?			X	
6. Has management shown a commitment to competence and ensured that personnel receive adequate training to perform their duties?	X			

CONTROL ENVIRONMENT EVALUATION

Write a brief risk analysis of ABC's Control Environment. Begin your analysis by evaluating risk as low, medium or high, then briefly explain your evaluation. Your response should not exceed one page and be written in an organized, professional and technical manner.

Section 5

CLIENT ACCEPTANCE AND PLANNING

Problem 1

What are the key procedures you would perform regarding client acceptance? Where would you get the data? Use the following format.

Procedure

Data

Problem 2

Identify any risks associated with this potential client that would impact your acceptance decision. Do not merely reiterate the potential risk discussed in additional information.

Problem 3

Assume the following is independent of the above problem(s).

Thomas Jefferson, an audit partner with your firm, has selected you to prepare a memo regarding the acceptance of ABC as an audit client. The audit will, if accepted, occur during the firm's slow season when there is excess employee capacity.

Consider the following:

1. The predecessor auditor explained that, due to disagreements on the application of GAAP, ABC Inc. chose to engage another auditing firm. The auditor, fearing litigation, would not specify the specific areas of disagreement.
2. ABC regularly pays its accounts payable 30-60 days late.
3. Management turnover has been excessive.
4. ABC is in a highly regulated, competitive industry.
5. Accounts Receivable turnover is 43 days.

Required:

Given the above information what procedures would you undertake regarding items 1-5.

Problem 4

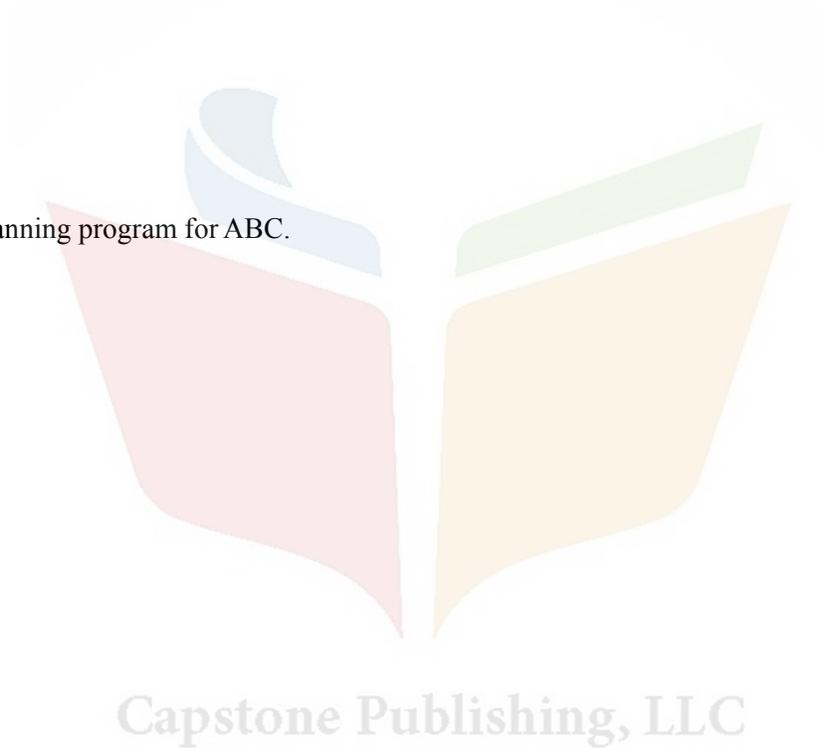
Using the client's financial statements and notes to the financial statements, determine what issues relating to GAAP to which the predecessor auditor may be referring.

Problem 5

Write an engagement letter for ABC. For any necessary engagement, specify information such as your fee. Use an amount of your choosing.

Problem 6

Write an audit-planning program for ABC.



Section 6

STATISTICAL AUDITING PROBLEMS

This section contains the following problems:

- **Attribute Sampling Problem 1**
- **Attribute Sampling Problem 2**
- **Probability Proportionate to Size Problem**
- **Variables Sampling Problem**



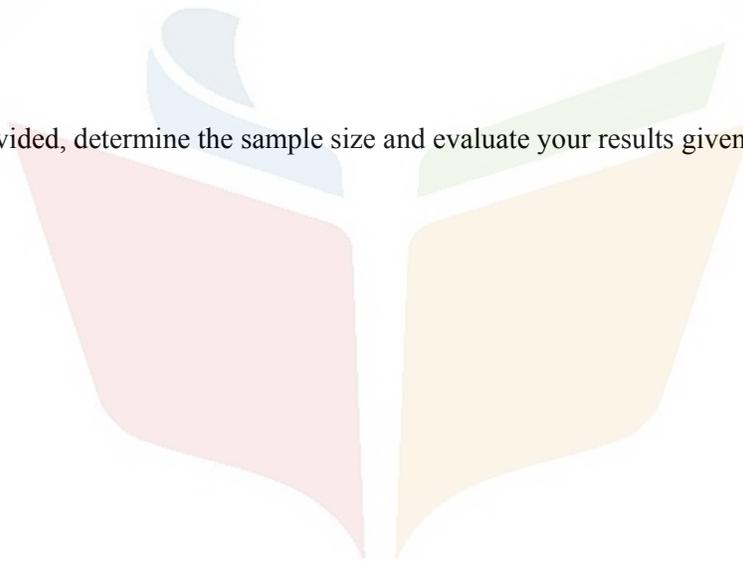
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ATTRIBUTE SAMPLING PROBLEM - 1

You have been assigned to test ABC's internal controls over credit authorization. You have determined that there are 20,000 sales invoices processed during the year. The parameters given to you by the audit manager are: 95% confidence that no more than 5% of the sales invoices were not approved (deviations). Based on last year's audit, it is estimated that approximately 1% of sales invoices deviate from the internal control being tested. You can accept a tolerable deviation rate of 5%. After selecting your sample you discover three deviations.

Required:

Using the tables provided, determine the sample size and evaluate your results given the three deviations uncovered.



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Statistical Sample Sizes for Test of Controls

Five Percent Risk of Assessing Control Risk Too Low
(number of expected errors in parentheses)

Expected Population Deviation Rate)	Tolerable Deviation Rate										
	2Yo	3Yo	4Yo	5Yo	6Yo	7Yo	8Yo	9Yo	10Yo	15Yo	20Yo
0.00	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
0.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*		185(7)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*		*	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*		*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*		*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*		*	*	*	68(5)	37(3)

*Sample size is too large to be cost-effective for most audit applications.

Note: This table assumes a large population.

Statistical Sampling Results Evaluation Table for Tests of Controls

Upper limits at five percent risk of assessing control risk too low.

Sample Size	Actual Number of Deviations Found										
	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.3	*	*	*	*	*	*	*
45	6.5	10.2	13.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	13.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	13.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	13.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

*Over 20 percent.

Note: This table presents upper limits as percentages and assumes a large population.

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ATTRIBUTE SAMPLING PROBLEM 2

Your firm has selected you to develop and assess the control risk over the shipping and billing functions of ABC Company. The audit manager would like to be able to assess internal control risk at low level. You wish to estimate control risk at the desired low level, therefore you selected a tolerable deviation rate of 20%.

To estimate the population deviation rate and the computed upper deviation rate, you have applied discovery-sampling techniques and use an expected population deviation rate of 3%. There are 8,000 shipping documents. You decided to postpone consideration of the allowable risk of assessing risk to low until the sample results were evaluated. You used the tolerable deviation rate, the population size, and expected population deviation rate to determine that a sample size of 80 should be sufficient.

Later you discovered that the actual population was 10,000 shipping documents. Therefore you have increased your sample size to 100. Your objective is to determine whether ABC's shipments have been properly billed. You took the sample of 100 invoices by selecting the first 25 invoices from the first month of each quarter then you compare those to the corresponding pre-numbered shipping documents.

You discovered eight deviations. Also, one shipment that should have been billed at \$10,440 was actually billed at \$10,500. You considered this amount to be immaterial and did not count it as an error.

In your evaluation, you made the initial determination that a 5% risk of assessing control risk to low was desired. Using the appropriate statistical sampling table, you determine that, for the deviations from a sample size of 100, the computed upper deviation rate was 14%. When you calculated the allowance for sampling risk, you determined it to be 5% - the difference between the actual sample deviation rate of 8% and the expected error rate, which you decided was 3%. You determine that the actual sample deviation rate of 5% was less than the computed upper deviation rate of 14%, plus it allows for sampling risk. Given this, you determined that the sample supported a low level of control risk.

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Required

Describe each incorrect assumption, statement and/or inappropriate application in the above procedures.

PROBABILITY PROPORTIONATE TO SIZE PROBLEM

You have selected 100 sample items from ABC's accounts receivable population. For this problem only, assume the total population for accounts receivable is \$500,000. Also assume the following invoices were selected. This is only a partial list of population items. Begin your selection with a random starting point of \$1,223.

Required

Which invoices would you select? Explain your answer.

Invoice Number	Recorded Amount
778	\$125
779	2,460
780	670
781	1,200
782	2,455
783	234
784	9
785	2,222
786	675
787	8,544
788	32
789	3,000
790	11,200

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VARIABLES SAMPLING PROBLEM

You have been charged to perform a test of controls over Accounts Receivable. You have selected the PPS sampling method because it automatically results in a stratified sample. You computed the sample size, using the risk of incorrect acceptance, the total recorded amount of receivables, and the number of misstated accounts allowed, and divided the total recorded book amount of receivables by the sample size in order to determine a sampling interval.

You have calculated the sample size to be 60 and the sampling interval to be \$10,000. Given this, only 50 different accounts were selected, because several of the accounts were so large that the sampling interval caused each of them to be selected twice. Given the results, you sent 55 confirmations. Three of the selected accounts in your sample had balances under \$20, therefore, you decided not to send them confirmations. Three accounts had negative balances.

You substituted the three largest accounts that had not been selected in the sample. Each of these accounts had a balance greater than \$7,000. The results of the confirmations revealed two differences. One difference showed an audit amount of \$3,000 but the amount had been recorded at \$4,000. Therefore, you projected this to be a \$1,000 misstatement. The other account had an audit amount of \$2,000 but had been recorded at \$1,900. You did not count the \$100 difference because the purpose the test was to detect overstatements.

As a result of this assumption, your valuation states that the Accounts Receivable balance was not overstated because the projected misstatements were less than the allowance for sampling risk.

Required

Discussed each incorrect assumption, statement and/or inappropriate application of the sampling procedures that you used.

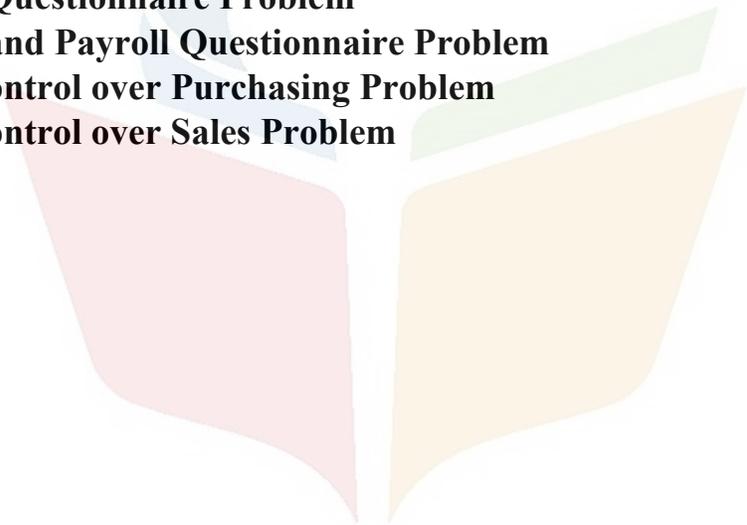
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Section 7

INTERNAL CONTROL PROBLEMS

This section contains the following problems

- **Internal Control Questionnaire and Assertions Problems**
- **Cash Handling Questionnaire Problem**
- **Receivables Questionnaire Problem**
- **Inventory Questionnaire Problem**
- **Personnel and Payroll Questionnaire Problem**
- **Internal Control over Purchasing Problem**
- **Internal Control over Sales Problem**



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Internal Control Questionnaire and Assertions

Assertions

Assertion	Coding	Description
Existence and occurrence	EO	Recorded transactions and events did occur and do pertain to the entity. Assets, liabilities, and equity interests exist. Disclosed events and transactions have occurred and pertain to the organization.
Completeness	C	All transactions and events that should have been recorded have been recorded. All assets, liabilities, and equity interests that should have been recorded are recorded. All disclosures that should have been included are included in the financial statements.
Rights and obligations	RO	The organization holds or controls the rights to assets, and liabilities are true obligations of the organization.
Valuation and allocation	VA	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuations of allocation adjustments are appropriately recorded.
Cutoff	CO	Transactions and events have been recorded in the correct accounting period.
Presentation and Classification	PC	Amounts and other data relating to recorded transactions and events have been recorded appropriately. Financial information is appropriately presented and described and disclosures are clearly expressed. Financial and other information is disclosed fairly and at appropriate amounts.

Required

Provide at least one assertion addressed by each control. Use the Coding above.

Cash

Example Control (1)	Item Number	Assertion Addressed
Cash general ledger accounts are reconciled to bank statements on a timely basis (daily, weekly, or monthly depending on volume of activity). Reconciling items are clearly identified on a reconciliation form and followed up on a timely basis. Reconciliations are regularly reviewed and approved by a supervisor.	1	
Employees who reconcile bank accounts are restricted from making general ledger entries or disbursing or wire-transferring funds from bank accounts.	2	
A person independent of the accounting and reconciliation functions receives the bank statements directly from the bank unopened and scans activity for anything unusual.	3	
EFT transactions may be initiated only by authorized individuals.	4	
Documented approval for a wire transfer is required to be obtained before the wire is executed. Callback procedures are used to validate the authenticity of the individual requesting the wire. Phone requests are accepted only for those customers for whom the bank has a completed wire transfer agreement on file and a PIN or preauthorized code has been assigned.	5	
There is appropriate segregation of duties between individuals involved in input, verification, and approval functions of the wire transfers.	6	
Prior approval for wire transfers in excess of preset limits is required.	7	
Data files are protected from unauthorized access through the establishment of user IDs and passwords that are periodically reviewed.	8	
Entity has control procedures in place to prevent unauthorized checks from clearing the bank or unauthorized amounts.	9	

Management periodically evaluates organizations where it has deposits for credit concerns. Uninsured balances are maintained only at	10	
Documentation is maintained relative to applicable restrictions on cash accounts. Restrictions are monitored and procedures are in place to ensure that cash is utilized only for restricted purposes.	11	
A control list of organizations with which the company has deposits is maintained. Financial statements prepared internally are reviewed consistently by a member of management to ensure that cash overdrafts are properly reported as liabilities.	12	
Compensating balance arrangements are identified and monitored.	13	

Investments - Gain/Loss on Sales of Investments

Example Control (1)	Item Number	Assertion Addressed
Statements from custodians of investments are reviewed monthly and reconciled to the general ledger by an individual independent of the cash recording or investment authorization function and are reviewed and approved by an independent person.	14	
Adjustments to fair value (unrealized gains and losses) and reconciliations are reviewed monthly by an individual independent of the cash recording or investment authorization function.	15	
Management performs monitoring procedures (obtains SAS 70 reports or sample tests individual investments) over investment managers to verify that fair market values, investment gains/losses, and interest and dividend yields reported by the manager are appropriate.	16	
A formal policy is in place relative to the accounting and maintenance of pooled investment funds, if applicable.	17	
Allocations across pooled investment accounts are computed and recorded and independently reviewed by a supervisory accountant (controller or CFO).	18	
Management maintains an investment policy that is reviewed and approved by the board or investment committee. Policy provides guidance on prudent investing and spending (i.e., establishing a spending formula) for investment funds.	19	

Management performs monitoring procedures over investment managers to ensure compliance with investment policy.	20	
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Transfers (including wire transfers) between investments and cash accounts are reviewed and approved before they are executed by an individual independent of the recording function.	21	
Appropriate individuals have been authorized to initiate and approve investment transactions with safekeeping agents, including identifying and removing securities from pledged status.	22	
Management properly monitors donor restrictions on income and investment gains and losses where such amounts are to be held for temporarily or permanently restricted purposes.	23	

Accrued Interest Receivable

Example Control (1)	Item Number	Assertion Addressed
Accrued interest receivable on securities/investments is balanced between general ledger and subsidiary records on a periodic basis. These reconciliations are routinely reviewed and approved by a supervisor.	24	
Accrued interest receivable/interest income is recomputed to ensure that amounts reported on investment statements appear appropriate.	25	
Yields for each investment category are computed periodically, and significant variances from expected yields are identified and followed up.	26	

Notes Receivable

Example Control (1)	Item Number	Assertion Addressed
Notes receivable accounts are properly reconciled monthly or periodically reviewed by an individual independent of the cash receipts function.	27	
Notes receivable are identified and supported by formal notes or by other documentation that is approved by authorized individuals.	28	
If notes are received at other than market rates, management performs an analysis of the impact on the carrying amount of the notes.	29	
Notes receivable are reviewed regularly for proper classification.	30	

Prepaid Expenses

Example Control (1)	Item Number	Assertion Addressed
Disbursements and payments are reviewed to determine whether they should be capitalized as prepaids and amortized over a defined term or expensed immediately.	31	
Detailed schedules/computations of prepaids are maintained and periodically reconciled to the general ledger. Remaining amortization periods are periodically reviewed for propriety. These reconciliations are routinely reviewed and approved by a supervisor.	32	
Management maintains documentation to support its right to prepaid assets.	33	
Prepaid assets are periodically subjected to impairment analysis.	34	
Insurance expenses (and other expenses that may be prepaid) are reviewed analytically and in comparison with budgeted amounts. Significant deviations from expectations are investigated and documented.	35	

Fixed Assets, Net of Accumulated Depreciation

Example Control (1)	Item Number	Assertion Addressed
Detailed records are maintained for property and equipment and their useful life and are periodically reconciled to the general ledger, including depreciation expense and gains and losses on sales and disposals.	36	
Formal capitalization policy has been created and has been approved by the board.	37	
Disbursements and payments for assets and repairs and maintenance are reviewed for capitalization or expensing in accordance with company policy.	38	
Appropriate individuals are assigned the responsibility for authorizing the acquisition of property and equipment.	39	
Computer equipment and other valuable assets susceptible to theft are physically safeguarded.	40	
Periodic inventory of property and equipment is taken, and that detail is compared with detail in subsidiary ledgers (both directions).	41	
Management maintains documentation to support its ownership of the premises and equipment.	42	
Computations of depreciation expense (either performed by system or through Excel spreadsheets) are periodically checked for accuracy.	43	
Management periodically performs an analysis to assess whether property and equipment has become impaired. Management has identified, and separated from other property and equipment, assets that are not in service, idle, abandoned, scrapped, or held for sale, and asset impairment is considered.	44	
For assets purchased in connection with a business combination or acquisition, costs of assets are allocated properly, based on their respective fair values, between depreciable and nondepreciable portions.	45	
New or modified leases are evaluated for operating versus capital lease decisions.	46	
Inventory of all operating and capital leases is maintained, and periodically updated for new or modified leases. Disclosures of lease commitments are accurately determined at year-end.	47	
Operating leases with rent escalation clauses are reviewed upon inception or renewal to determine the appropriate method to use to record lease expense.	48	

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Depreciation, repairs and maintenance, and other related expenses are reviewed for appropriate classification (functional expense categories - FASB organizations only).	49	
Significant construction contracts are reviewed and approved by the board prior to executing the agreement.	50	
During construction periods, management performs an analysis to determine the need to capitalize interest costs.	51	
Repairs and maintenance, leases/rents, and depreciation expense are reviewed analytically by management and compared with budgeted amounts. Significant deviations are investigated and documented.	52	

Intangibles, Net of Accumulated Amortization

Example Control (1)	Item Number	Assertion Addressed
Accounting entries made to record intangibles acquired in a business combination transaction and any interest rate adjustments recorded for acquired interest-bearing assets and liabilities are adequately supported and reviewed by management to ensure accuracy.	53	
Loan issuance costs are adequately supported and reviewed by management to ensure accuracy.	54	
Identifiable intangible assets and any interest rate adjustments are reconciled to supporting schedules, and such reconciliations are reviewed and approved.	55	
Fair values assigned to the intangible assets and any interest rate adjustments assigned to interest-bearing assets and liabilities of the acquired entity are based on reliable data, reliable appraisals, reasonable assumptions, and/or market data and are reviewed by management to ensure accuracy.	56	
Management documents and retains its periodic testing of the carrying value of intangible assets and any interest rate adjustments, including comparing actual results in subsequent accounting periods to the estimates and assumptions made in recording intangible assets and any interest rate adjustments at the purchase date. Identifiable intangible assets and any interest rate adjustments are reviewed for continuing validity in each subsequent accounting period.	57	

Reasonable lives are estimated for identifiable intangible assets and any interest rate adjustments, and the values assigned are amortized to expense over the respective lives. Amortization expense entries are reviewed and approved.	58	
If the straight line method of amortization is used for loan issuance costs, management has performed an analysis to determine that the difference between the straight line method and the effective interest method is not material.	59	

Inventory

Example Control (1)	Item Number	Assertion Addressed
An inventory count is adequately planned and staffed; employees are appropriately trained and supervised; and there are written instructions for the count, which is performed at or near year-end.	60	
Inventory is counted by people who are familiar with the product and are independent of inventory recordkeeping.	61	
The inventory count is adequately supervised by employees who are independent of custodial responsibilities, shipping, receiving, or purchasing.	62	
A well-designed perpetual system is in place and adequate controls are in place to ensure timely recording of incoming and outgoing products. Perpetual records are kept by someone who doesn't have responsibility for the stock, periodic cycle or test counts are performed, and differences are investigated and resolved timely.	63	
Obsolete, slow-moving, or damaged items are physically segregated and identified by management.	64	
Movement of inventory is stopped during the physical count.	65	
Counts and pricing of items are independently double-checked by a second employee.	66	
The company periodically analyzes inventory quantities, aging of product, replacement costs, sales backlogs, and trends to identify products that may have a market value less than cost and provides appropriate valuation allowances if necessary.	67	

Other Assets

Example Control (1)	Item Number	Assertion Addressed
Detailed records of other assets are maintained and periodically reconciled to the general ledger. These reconciliations are routinely reviewed and approved by a supervisor.	68	
Other assets and other related accounts are reviewed by management on a monthly basis, and any unusual relationships or trends are investigated and resolved.	69	
Management maintains documentation to support its right to other assets.	70	
Other asset accounts are reviewed and updated regularly for classification, realization (cash receipt), and impairment.	71	
Management reviews other assets and ensures that they are recognized in the proper period.	72	

Accounts Payable

Example Control (1)	Item Number	Assertion Addressed
Purchases require approved purchase order or written approval by authorized individual.	73	
Check signers are not check preparers.	74	
Bank signature cards are updated as appropriate upon personnel changes.	75	
Blank checks are prenumbered and are maintained in a secure location, and sequence is accounted for.	76	
The computer system does not allow an invoice number to be posted twice.	77	
Signature authority over bank accounts (including authority to transfer funds among accounts and process EFTs) is restricted to management personnel not responsible for recording cash disbursements or reconciling bank accounts.	78	
Signed checks are mailed by employees who are independent of disbursements and accounts payable functions.	79	
Dual signatures are required for checks and disbursements over a specified limit.	80	
Original invoices and supporting documents are canceled to prevent duplicate payment.	81	
Vendor invoices are processed by accounts payable clerk(s) who is (are) independent of purchasing, receiving, and cash functions (not an authorized check signer or not responsible for posting of cash receipts).	82	

Only authorized individuals can add to the accounts payable approved vendor master file and accounts payable detail file, and changes are independently reviewed.	83	
The entity establishes timely control over all invoices received (for example, they are promptly entered into a purchases journal and subsidiary ledger).	84	
The accounts payable clerk does not have the ability to post general journal entries.	85	
Invoices include notations by authorized personnel relative to the posting of payables to the proper period.	86	
Invoices include notations by authorized personnel relative to the posting of the related expense to the proper account.	87	

Notes Payable, Debt, and Other Borrowings

Example Control (1)	Item Number	Assertion Addressed
Borrowings shown on the general ledger are reconciled to statements on a regular basis. Reconciliations are reviewed by an appropriate supervisor.	88	
Appropriate segregation of duties exists between individuals involved in approving borrowings and recording/reconciling the accounts.	89	
Borrowings are authorized by board of directors, finance committees, or other appropriate individuals.	90	
Approval of hedges used in complex/structured financial instruments is required by shareholders, board of directors, finance committees, or other appropriate individuals.	91	
A system to monitor debt covenants on an ongoing basis is established, and covenants are calculated and approved in writing by an authorized individual.	92	
Classification of long-term debt is reviewed by authorized individual and compared with appropriate loan documentation.	93	

Accrued Interest Payable, Interest Expense

Example Control (1)	Item Number	Assertion Addressed
Accrued interest payable on borrowings is balanced from the subsidiary ledger to the general ledger on a periodic basis by an individual with no conflicting duties. These reconciliations are routinely reviewed and approved by a supervisor.	94	

Accrued interest payable/interest expense on borrowings is reconciled to the lenders' statements to validate expense recognition and valuation of accrued interest payable.	95	
Accrued interest payable/interest expense on borrowings is computed by IT system to allow for reliable expense recognition and valuation of accrued interest payable. Management periodically verifies the accuracy of system calculations for all borrowing types.	96	
Interest expense is reviewed analytically and compared with budgeted amounts by management on a periodic basis. Significant deviations from expectations are investigated and documented.	97	

Accrued Payroll Liabilities, Salaries, and Wages Expense

Example Control (1)	Item Number	Assertion Addressed
Changes to payroll master files (pay rates, employees, deductions, etc.) are approved in writing by someone independent of payroll disbursement.	98	
The computation of accrued payroll, bonuses, and other related liabilities (compensated absences, taxes, benefits, etc.) are reconciled with the general ledger and reviewed and approved by an authorized individual.	99	
Wages and other related payroll expenses are periodically reconciled to payroll system reports.	100	
Wages and other related payroll expenses are reviewed analytically and in comparison to budgets. Significant deviations from expectations are investigated and documented.	101	
For outsourced payroll functions, SAS 70 reports are obtained and reviewed by management for control deficiencies and user control considerations.	102	
Timecards or other pertinent time records are approved by supervisors.	103	
Formal policy is in place outlining the treatment for unused vacation and sick days (i.e., if amounts carry over or are eligible for payout).	104	
Unused vacation and/or sick days are tracked by human resources, and information is available for management to accurately determine the need for appropriate accruals.	105	
Payroll reports are reviewed and approved by an appropriate individual to ensure that fictitious employees are not present.	106	
Payroll change reports from payroll service company are reviewed by someone independent of the payroll processing function.	107	

Accrued Expenses and Other Liabilities

Example Control (1)	Item Number	Assertion Addressed
Detailed records for other liabilities are maintained and periodically reconciled to the general ledger. Reconciliations are prepared by an individual who is not responsible for the approval and recording of transactions.	108	
Other liability accounts are periodically reviewed by management for reasonableness.	109	
Management reviews and records contingent liabilities based on legal counsel's evaluation of the status of lawsuits and in accordance with FAS five.	110	
Management obtains and reviews estimates from independent third parties.	111	
Management reviews expenses to determine proper allocation between funds/functional expense categories.	112	
Management reviews other liability expenditures and ensures that they are expensed and recognized in the proper period.	113	

Net Assets

Example Control (1)	Item Number	Assertion Addressed
Entries are not made to fund equity/net assets without proper support and approval by management of the organization.	114	
Agreements are kept and maintained for permanently restricted endowment funds, to serve as documentation for the nature of restrictions on the initial gift as well as restrictions on the use of gift income.	115	
Accounting records are structured in a manner that allows restricted contributions to be tracked separately.	116	
Restrictions to fund equity/net assets are reviewed by management.	117	
Designated individuals are responsible for ensuring that restricted contributions are properly accounted for, to ensure compliance with donor terms and conditions, including time or purpose restrictions.	118	
Management reviews classifications of net assets/fund balances at end of fiscal year.	119	
Governmental net asset restrictions are reviewed for proper classification of "expendable" and "nonexpendable."	120	

Allowance for Doubtful Accounts

Example Control (1)	Item Number	Assertion Addressed
Agings of receivables are prepared monthly and reviewed by management in conjunction with credit decisions and determining necessary allowances.	121	
A detail is maintained for all receivables assigned to collection agencies and included in determining the necessary allowance.	122	
Write-off of receivables/claims is approved by an authorized person, an individual independent of the cash receipts function.	123	
Reserve assumptions are validated by an approved policy.	124	
Credit policies are established by management and enforced by a credit manager or other appropriate individual independent of the sales/revenue and cash receipts functions.	125	

Related-Party Transactions

Example Control (1)	Item Number	Assertion Addressed
Related-party transactions are properly authorized by appropriate individuals.	126	
Management maintains a complete list of all related parties and related-party transactions.	127	
Related-party receivables/payables are periodically reconciled to the related-party books and records.	128	
Management has access to related-party financial information and reviews for the intent and ability of the related party to repay.	129	
Management verifies that receivables/payables are properly classified (i.e., long-term versus short-term, distributions versus receivable, etc.).	130	
There is a formalized system in place to aggregate information on loans to related parties. Related-party loans are separately coded on the loan trial balance, approved by the board, and properly underwritten.	131	

Cash Handling Questionnaire

Question	Yes	No	N/A or Un	<u>Tests</u>
Cash and Check Receipt Handling (answered by the controller)				
1. For payments received by mail, is a mail log maintained by hand in ink to prevent alteration that lists the date of receipt, amount of check, etc.?	X			
2. Is the mail log prepared by someone independent of the cash receipts process?		X		
3. Are checks stamped with a restrictive endorsement immediately upon receipt?		X		
4. Is cash counted and verified when cashiers receive checks from the mailroom?	X			
5. Is cash, at all times, in the possession and control of only one person?	X			
6. Is a receipt given for all transactions that are conducted in person?			X	

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Question	Yes	No	N/A or Unk	<u>Tests</u>
7. Are duplicate copies of receipts retained?	X			
8. Are relevant documents issued in sequence?	X			
9. Are voided pre-numbered documents kept and accounted for?	X			
Question	Yes	No	N/A Or Unk	<u>Tests</u>
Cash and Check Deposits				
1. Are receipts recorded promptly and deposited within 24 hours if greater than \$500, or at least once weekly if less?		X		
2. Are all funds received deposited with no funds being held back for change, petty cash, etc.?	X			
3. Are deposit slips prepared in at least duplicate form?	X			
4. Do you use either a locking bank bag or a sealing plastic tamper proof bag for deposit?		X		
5. Do two people accompany the departmental deposit from the office to the nearest depository?		X		
Company and Departmental Policies and Procedures				
1. Do you perform background checks and fingerprinting on all new employees who handle cash?		X		
2. Do all personnel who handle cash have access to, and knowledge of, the applicable company policies?	X			

3. Are departmental policies and procedures current and in writing regarding how the department is to comply with Company requirements regarding the receipt, recording, safeguarding, deposit, and reconciliation of receipts? (Receipts include cash, checks, and credit card transactions.)	X			
Management Oversight and Reconciliation				
Question	Yes	No	N/A or Unk	<u>Tests</u>
1. Are all resulting discrepancies investigated and resolved?	X			
2. Does someone independent of the cash receipts process reconcile payment receipts to deposit slips on a daily basis?		X		
3. Is the payment receipt to deposit reconciliation regularly reviewed by management?		X		
4. Does someone independent of the cash receipts process reconcile payment receipts to receipt records?		X		
5. Does someone independent of the cash receipt process reconcile receipts records (receipts, mail log, cash register) to the deposit slip?	X			
6. Is the receipt record to deposit slip reconciliation regularly reviewed by management?		X		
7. Are visible indicators of management reviews (such as initials and dates) evident on reconciliations and other reports?	X			
Question	Yes	No	N/A or Unk	<u>Tests</u>
Safeguarding of Assets				
1. Are adequate physical facilities such as a safe or locking drawer provided for safeguarding cash?	X			

2. Is cash always safeguarded when unattended?	X			
3. Are receipt books safeguarded when unattended?	X			
4. Are safe combinations and keys to lockboxes restricted to a minimum number of employees?	X			

Control activities are policies & procedures that help ensure that management directives are followed.

The auditor will be concerned about.

- **Performance reviews**-comparisons of actual performance to expectations.
- **Information processing**-checks on accuracy, completeness, & authorization of transactions.
- **Physical controls**-safeguarding assets & controlling access to records.
- **Segregation of duties**-reducing opportunities for one individual to commit errors & conceal them.

Duties requiring segregation are.

- Authorization.
- Recording.
- Custody.
- Comparison.

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Problem 1

What tests of control would you apply for each of the “yes” responses?
(Do not answer using a narrative). Label each test as such:

Cash and Check Receipt Handling

<u>Item</u>	<u>Tests</u>
1	
4	
5	
7	
8	
9	

Problem 2

What weight do you give each of the “no” responses? Use a scale of 1 – 5 with “1” being “not serious” and “5” being “very serious.” Which IC control is violated: Performance review, Information Processing, Physical Control or Segregation of Duties? Total all of the weights, evaluate the complete questionnaire responses and rate internal control risk for cash as “low”, “moderate,” or “high.” Use the following format.

<u>Response</u>	<u>Which IC control is violated</u>	<u>Weight Given</u>
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Receivables Questionnaire

(answered by the ARManager)

Question	Yes	No	N/A or Unk	<u>Tests</u>
1. Are credit and collection and write off policies and procedures current and in writing?	X			
2. Are these policies and procedures clearly stated and systematically communicated?	X			
3. Are the responsibilities for maintaining detailed accounts receivable records segregated from collections, disbursement, and general ledger posting functions?	X			
4. Are disputed liabilities handled by person(s) other than those receiving payment and record keeping functions?		X		
5. Do controls in the system exist that provide assurances that individual receivable records are posted only from authorized source documents?	X			
6. Are controls maintained that provide assurances that customer database and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed?		X		
7. Are billings controlled and properly accounted for?	X			
8. Is there adequate control over the mailing of statements to prevent interception prior to mailing?		X		

9. Are statements of account balance mailed on a timely basis, where appropriate?	X			
Question	Yes	No	N/A or Unk	<u>Tests</u>
10. Are aggregate collections on accounts receivable reconciled against postings to individual receivable accounts?	X			
11. Are all valid receivables promptly recorded?	X			
12. Are aged accounts receivable balances periodically reviewed by supervisory personnel?	X			
13. Do adequate procedures exist for follow-up and collection of delinquent accounts?	X			
14. Are there controls to insure that individuals with delinquent accounts are precluded from receiving additional credit?	X			
15. Are delinquent accounts reviewed and considered for charge-off on a timely basis?	X			
16. Are write-offs or other reductions of receivables, including non-cash credits, credit memos, and allowances, formally approved by senior officials not involved in the collection and recording function?	X			
17. Do procedures exist that ensure that interest and penalties are properly charged on delinquent accounts?	X			
18. Are credit balances periodically reviewed?	X			

Control activities are policies & procedures that help ensure that management directives are followed.

The auditor will be concerned about.

- **Performance reviews**-comparisons of actual performance to expectations.
- **Information processing**-checks on accuracy, completeness, & authorization of transactions.
- **Physical controls**-safeguarding assets & controlling access to records.
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Duties requiring segregation are.

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- Comparison.



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Problem 1

What tests of control would you apply for each of the “yes” responses?
(Do not answer using a narrative). Label each test as such:

Receivables

<u>Item</u>	<u>Tests</u>
1	
2	
3	

Problem 2

What weight do you give each of the “no” responses? Use a scale of 1 – 5 with “1” being “not serious” and “5” being “very serious.” Which IC control is violated: Performance review, Information Processing, Physical Control or Segregation of Duties? Total all of the weights, evaluate the complete questionnaire responses and rate internal control risk for as “low”, “moderate,” or “high.” Use the following format.

<u>Response</u>	<u>Which IC control is violated</u>	<u>Weight Given</u>
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Inventory Questionnaire

(answered by the Purchasing Manager)

Question	Yes	No	N/ A Or Unk	<u>Tests</u>
1. Are policies and procedures current, in writing, and properly approved?	X			
2. Are these policies and procedures clearly stated and systematically communicated?	X			
3. Are receiving, issuing, accounting and storing responsibilities properly segregated?	X			
4. Has management taken the appropriate steps to safeguard goods against risk of loss by theft (e.g., goods kept in locked buildings, rooms, or cages, access to which is granted only to authorized personnel)?	X			
5. Do departments compare quantities received against receiving reports, etc.?	X			
6. Is material released from storerooms only on the basis of requisitions which are approved by a responsible official of the department?	X			
7. Is adequate provision made for obsolete and inactive items in inventories?	X			

Question	Yes	No	N/A Or Unk	<u>Tests</u>
8. Does management monitor and approve the write-offs of obsolete and inactive inventories?	X			
9. Where details are kept as to value, are they reconciled to general ledger controls at reasonable intervals (at least annually)?	X			
10. Are all classes of inventory items physically counted annually?	X			
11. Do procedures for physical counts provide for:				
a. Adequate written instructions?	X			
b. Adequate supervision?	X			
c. Clearly marking damaged and obsolete inventory?	X			
d. Use of pre-numbered tags which are accounted for?		X		
e. The counting of the items and access to the tags only by employees who are not responsible for custody of the particular items?			X	
f. Careful investigation of significant overages and shortages?	X			
g. Prompt adjustment of records for inventory discrepancies after approval by a responsible official other than stores personnel?		X		
h. The signing and dating of inventory count sheets by the person supervising the count?		X		

Question	Yes	No	N/A Or Unk	<u>Tests</u>
12. *Does management review the reconciliation of physical inventory counts to the inventory records?		X		
13. Are adequate provisions made for cut-off of receipts and issues?		X		
14. Is adequate insurance coverage provided?	X			
15. Are detailed perpetual inventory records periodically reviewed for slow-moving items?	X			
16. Is a perpetual inventory system (including quantities and value) in use as to all major classes of inventory?	X			
17. Are perpetual inventory records updated promptly?	X			
18. Are the postings to the perpetual inventory records made promptly from:				
a. Pre-numbered, signed receiving reports?	X			
b. Issue requisitions?	X			
19. Are additions to perpetual inventory records referenced to supporting invoices to insure easy verification of the records?		X		
20. Are inventories taken without prior reference to quantities on perpetual records?	X			
21. Are discrepancies between physical counts and perpetual records investigated and resolved?	X			

Control activities are policies & procedures that help ensure that management directives are followed.

The auditor will be concerned about.

Performance reviews-comparisons of actual performance to expectations.

Information processing-checks on accuracy, completeness, & authorization of transactions.

Physical controls-safeguarding assets & controlling access to records.

Segregation of duties-reducing opportunities for one individual to commit errors & conceal them.

Duties requiring segregation are.

- Authorization.

- Recording.

- Custody.

- Comparison.



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Problem 1

What tests of control would you apply for each of the “yes” responses?
(Do not answer using a narrative). Label each test as such:

Inventory	
<u>Item</u>	<u>Tests</u>
1	
2	
3	

Problem 2

What weight do you give each of the “no” responses? Use a scale of 1 – 5 with “1” being “not serious” and “5” being “very serious.” Which IC control is violated: Performance review, Information Processing, Physical Control or Segregation of Duties? Total all of the weights, evaluate the complete questionnaire responses and rate internal control risk as “low”, “moderate,” or “high.” Use the following format.

<u>Response</u>	<u>Which IC control is violated</u>	<u>Weight Given</u>
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Personnel and Payroll Questionnaire

(answered by the Manager of Human Resources)

Question	Yes	No	N/A or Unk	<u>Tests</u>
1. Are policies and procedures relevant to the payroll cycle current and in writing?	X			
2. Are these policies and procedures clearly stated and systematically communicated?	X			
3. Is there a separate personnel department which maintains complete personnel records including job description, wage and salary data?	X			
4. Is access to the IT personnel master file limited to appropriate employees? Are changes to the master payroll file approved and documented?	X			
5. Are appropriate regulations being followed in regard to payroll withholdings, wages and hours, and other Federal, state and local requirements concerning employment?	X			
6. Are the reports that provide the details of the payroll amounts charged to the department's accounts reviewed and compared to a copy of the approved Standard Time Report (and any approved Time Report Adjustments, if applicable) by someone who did not prepare the Standard Time Report?		X		

7. Has a payroll checking account been established? Is the account:			X	
Question	Yes	No	N/A or Unk	<u>Tests</u>
a. Maintained on an imprest basis?			X	
b. Reconciled on a regular basis?			X	
8. Are written authorizations from responsible persons outside the payroll department required for:				
a. Names added to and deleted from the payrolls?	X			
b. Individual wage or salary rate changes?	X			
9. Are individual employee time and attendance records:				
a. Prepared and signed by each employee for each pay period?		X		
b. Sufficiently detailed to show time charges to assignments, leave and administration?	X			
c. Reviewed and signed by each employee's supervisor?		X		
d. Reconciled with centralized time and attendance records?	X			
10. Has a prescribed system been developed in writing to accrue and use vacation, sick leave and	X			
11. Are appropriate records maintained for accumulated employee benefits (vacation, sick leave, comp time, etc.) and checked for overdrawn balances prior to the submission of the employee time and attendance report?	X			
12. Are the persons who perform the following functions independent of each other:				
a. Approve hours worked?	X			
b. Prepare the payrolls?		X		

c. Distribute the pay?		X		
b. Personnel recordkeeping?		X		
13. Is the distribution of payroll charges checked by a second independent person and are aggregate amounts compared to the approved budget before disbursements are made?		X		
14. Are payrolls subject to a review and final approval by responsible persons outside the payroll department such as department heads, etc. before disbursements are made?		X		
15. Is the current payroll (i.e., gross payroll, number of employees) reconciled to the previous payroll?		X		
16. Are the persons who manually sign the checks or control use of the facsimile signature plates				
a. Approving hours worked?	X			
b. Preparing the payrolls?		X		
c. Operating the facsimile signature machine?		X		
17. Are unused and unclaimed checks accounted for and secured?				
18. Do separation procedures include an employee interview as a final review of any termination settlement by the personnel department?		X		
19. Have procedures been established for year-end cutoff to ensure that payroll expenditures are recorded in the appropriate fiscal year?	X			

Control activities are policies & procedures that help ensure that management directives are followed.

The auditor will be concerned about.

- Performance reviews-comparisons of actual performance to expectations.
- Information processing-checks on accuracy, completeness, & authorization of transactions.
- Physical controls-safeguarding assets & controlling access to records.
- Segregation of duties-reducing opportunities for one individual to commit errors & conceal them.

Duties requiring segregation are.

- Authorization.
- Recording.
- Custody.
- Comparison.

Problem 1

What tests of control would you apply for each of the “yes” responses? (Do not answer using a narrative). Label each test as such:

Personnel and Payroll	
<u>Item</u>	<u>Tests</u>
1	
2	
3	

Problem 2

What weight do you give each of the “no” responses? Use a scale of 1 – 5 with “1” being “not serious” and “5” being “very serious.” Which IC control is violated: Performance review, Information Processing, Physical Control or Segregation of Duties? Total all of the weights, evaluate the complete questionnaire responses and rate internal control risk as “low”, “moderate,” or “high.” Use the following format.

<u>Response</u>	<u>Which IC control is violated</u>	<u>Weight Given</u>
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Internal Control over Purchasing Problem

For non-routine orders, the user department completes a purchase requisition. One copy is filed in the user department and one copy is sent to the purchasing agent. The purchasing agent then processes the request by completing a three-part purchase order and process as described below. For routine orders, the purchasing agent proceeds as discussed below.

After shipments are processed against the inventory master file, the agent records an EOQ, which is a software routine in the inventory-purchases module, and generates an inventory reorder report and a daily listing of items requiring reorder. The purchasing agent uses this report to select items for reorder. Once she has selected the items from the report, she uses the LAN and inventory-purchases module to initiate the preparation of a purchase order.

The program updates a field in each applicable vendor master file record to indicate the items that are on order from each selected vendor. The software also prints purchase orders in three parts, along with a report listing the purchase orders. The purchasing agent sends the first copy of the first order to the vendor and places the second copy in the open purchases order file pending receipt of the vendors invoice and the receiving report. She sends a copy of the purchase order report containing the on-order items to the inventory storeroom clerk. The clerk is able to access the report data items on the LAN. The menu on the computer screen allows her to accept the data in the report and thereby update the quantity order field in each applicable inventory master file record.

The third copy of the purchase order is used as a receiving report. Upon receipt, clerks count the material and record the quantities received on the receiving report copy. The receiving personnel enters the receipts into the LAN software, which updates the “merchandise received” field in the applicable inventory master file record to indicate that the material has been received. The module also prints a daily receiving log. Merchandise and the third copy of the purchase order are sent to the warehouse, where the merchandise is counted. After verifying the receiving clerk’s count and reconciling any discrepancies, the data is input into a computer screen template. The LAN software updates the relevant inventory master file record by increasing the quantity on hand. Any differences between the quantity received and the quantity ordered are listed on the report that is sent to the purchasing agent, along with the third copy of the receiving report. The purchasing agent accesses this report from the LAN and uses it to reconcile any differences with the vendor.

Required

Evaluate internal control risk over purchases using “low,” “moderate,” or “high” risk categories. Explain your answer.

Internal Control over Sales Problem

Customers' orders are received by the sales staff, who enter it into the sales-order entry module of the information system. The program performs an online update of the customer's master file and generates a transaction report of sales entries by customer. The data in this report are accessed through the LAN by the sales manager, who prints out the report. The sales staff enters any necessary corrections and uses a menu within the sales order entry module to generate invoices from the customer's master file. Two-part customer invoices, as well as two copies of the report listing the invoice, are generated and printed. At the time the invoices are processed, the sales order entry module updates the inventory master file by reducing the balance in each relevant inventory master file record.

The original sales invoice, along with one copy of the invoice *report*, are sent to the bookkeeper. Once the items ship, the bookkeeper mails the original copy to the customer. The second *of the report*, along with the second copy of the invoice, are sent to the inventory storeroom clerk. She reviews the invoice for errors, such as items that are out of stock, but are reported to be in stock by the sales order entry system.

She accesses the inventory master file then records and makes corrections for any noted errors. She then pulls the ordered items from the shelf and sends the merchandise and the invoices to the repackaging area to fulfill the customers' orders. After marking the quantity on the stock request copy, the repackaging personnel sends this copy and the order to shipping. When the order is shipped to the customer, shipping personnel include the stock request as a package slip. The shipping personnel also enter data from the stock request copy into the sales order entry module to produce a shipping report, which updates a field in the customers' master file indicating that the customers' orders were shipped.

At the end of the day, the sales order entry module processes a report of the items that were shipped. The bookkeeper accesses this report and sends the original copy of the invoice to the customer. She uses the journal entry transaction file generated by the sales order entry module to update the general ledger master file. Additionally, the sales order entry module automatically updates the accounts in the customer master file for each customer who ordered merchandise. These data are later used by the accounts receivable application.

Lastly, the bookkeeper prepares a billed customer report that serves as the sales register. This report is accessible on the LAN for use by the accounts receivable clerk. The Accounts Receivable application includes an option allowing the accounts receivable clerk to generate a listing of each customer's balance and a balancing report that provides a reconciliation of the

Accounts Receivable subsidiary ledger to the general ledger accounts receivable control account. The Accounts Receivable clerk prepares a printout of the Accounts Receivable subsidiary ledger and the balancing report at the end of the day after all sales and cash receipts have been processed.

Required

Evaluate control risk over sales using “low,” “moderate” or “high” risk categories. Explain your answer.



Section 8

SUBSTANTIVE TESTING PROBLEMS

This section contains the following problems

- **Cash Problem**
- **Accounts Receivable Problem**
- **Investment Objectives Problem**
- **Current Liabilities Problem**
- **Long-term Liabilities Problem**



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Cash Problems

Problem 1

Review the following information:

You have prepared the following inter-bank transfer schedule for ABC.

Transfer Recorded	Check Amt	Disbursed recorded in book	Date recorded by bank	Receipt recorded in books	Date recorded by bank
1	\$5,000	12/31/13	01/04/14	12/31/13	12/31/13
2	\$10,000	01/04/14	01/05/14	12/31/13	01/03/14
3	\$150,000	12/31/13	01/05/14	12/31/13	01/04/14
4.	\$30,000	01/04/14	12/31/13	12/13/14	01/04/14

What is the effect of the above on cash in bank accounts?

Problem 2

Provide one piece of documentation (not procedure) that is relevant to cash and that provides evidence for each of the following assertions.

- Presentation and disclosure
- Rights and obligations
- Existence and occurrence
- Completion and cutoff
- Valuation

Problem 3

You evaluate cash internal controls and conclude the IC risk as being low. You have also estimated inherent risk as low. Prepare a cash audit program.

Problem 4

Provide three other accounts that are indirectly audited when you audit cash.

Accounts Receivable Problems

Problem 1

Assume you have evaluated Accounts Receivable internal control and conclude that there is a low risk that there is a material misstatement in accounts receivable. Prepare an audit program.

Problem 2

In addition to the procedures in problem 1, what additional procedures would you perform if you concluded that there is a high risk of a material misstatement in accounts receivable?

Problem 3

Using PPS, the in-charge auditor has calculated that a sample of 117 account receivable invoices should be selected to help determine the accuracy of the AR balance. The invoices were selected and confirmations were sent. The following issues were uncovered. What is your response to each of the issues?

- a. Confirmation #34 was not returned.
- b. Confirmation #21 was sent back with a comment from the customer saying the amount was paid in January.
- c. Confirmation #74 was returned with a comment that the amount is too high due to a returned shipment by the customer.
- d. Confirmation #82 was returned to your client.
- e. Confirmation #98 was returned with a comment stating that the customer only keeps books as a total balance not individual invoices.

Problem 4

Provide one piece of documentation (not a procedure) that is relevant to accounts receivable and provides evidence for each of the following assertions.

- a. Presentation and disclosure
- b. Rights and obligations
- c. Existence and occurrence
- d. Completion and cutoff
- e. Valuation

Problem 5

List three accounts that are indirectly audited when you audit accounts receivable. One of the accounts must be an income statement account.

Investment Objectives Problem

AUDIT OBJECTIVES

A. The balances reflect a complete listing of investments, and the company's ownership of such assets is evidenced by securities or other appropriate legal documents either physically on hand or held in safekeeping by others.

B. Asset values, investment income or loss, valuation allowances, gains or losses on sales of investments, and changes in fair value are recorded and presented in accordance with GAAP.

C. Investments are properly described and classified in the balance sheet, and disclosures have been made for any restrictions, pledges, or liens against the assets. The disclosures required by GAAP have been made.

D. Derivatives are properly identified and measured as assets or liabilities, and changes in fair value are recorded and presented in accordance with GAAP. The disclosures required by GAAP have been made.

Problem 1

For items A-D above, give at least one management assertion.

Problem 2

For each of your answers above, provide one test you apply to verify each objective.

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Current Liabilities and Contingencies Problems (CLC)

Problem 1

Assume the two scenarios:

- a. You evaluate CLC internal controls and determine the IC risk as being low. You have also estimated inherent risk as low. The total balance in CLC is relatively low.
- b. You evaluate CLC internal controls and determine the IC risk as being at the maximum. You have also estimated inherent risk as being moderate. The total balance in CLC is very material.

Required

Create two separate audit programs – one for each of the scenarios above. For each program, provide the management assertion applicable to the procedure.

Problem 2

Provide one piece of documentation (do not give procedures) that is relevant to CLC and provide evidence for each of the following assertions.

- a. Presentation and disclosure
- b. Rights and obligations
- c. Existence and occurrence
- d. Completion and cutoff
- e. Valuation

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Problem 3

List three accounts that are indirectly audited when you CLC. One of the accounts must be an income statement account.

Long-term Liabilities Problems

Problem 1

Assume the following:

You evaluate long-term liabilities internal controls and conclude the IC risk as being at the maximum and inherent risk is moderate. The total balance in long-term liabilities is material.

Required

Write an audit program.

Problem 2

What procedures from problem 1 would you eliminate if IC risk and inherent risks are low?

Problem 3

Provide one piece of documentation (do not give procedures) that is relevant to long-term liabilities and provides evidence for each of the following assertions.

- a. Presentation and disclosure
- b. Rights and obligations
- c. Existence and occurrence
- d. Completion and cutoff
- e. Valuation

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Problem 4

List three accounts that are indirectly audited when you audit long-term liabilities. One of the accounts must be an income statement account.

Section 9

COMPLETING THE AUDIT

You have finally evaluated internal control and performed the necessary substantive procedures based on the internal control evaluation.

Problem 1

Provide five analytical procedures you would perform at the end of the audit. Do not use the procedure discussed in Problem 2.

Problem 2

Assume that you calculated the ratio of depreciation expense to equipment and found a significant decrease in the ratio. Give two possible explanations.

Problem 3

What are your reporting responsibilities to the Board of Directors or audit committee?

Problem 4

What are your responsibilities regarding subsequent events? What procedures would you perform, if any?

Problem 5

Address the following:

Assume you found that the segment previously discussed was actually sold on February 20, 2014.

A major customer (accounting for 18% of total revenue) declared bankruptcy January 27, 2014.

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Section 10

WRITING THE REPORT

Problem 1

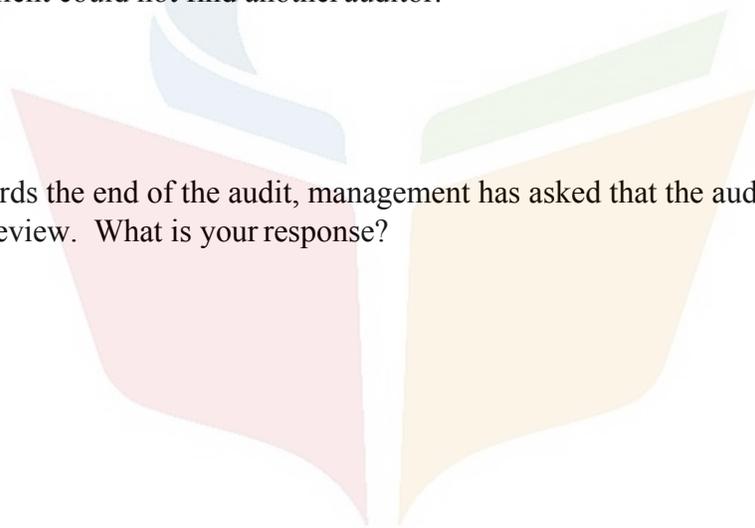
Write the audit report assuming that the predecessor auditor qualified last year's audit report.

Problem 2

How would your audit report change, if at all, if the predecessor auditor withdrew from the audit last year and refused to be associated with the report or the company's statements? Given the late date, the client could not find another auditor.

Problem 3

Assume that, towards the end of the audit, management has asked that the audit be downgraded to a review. What is your response?



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