

PCAOB Webinar: Auditing in the Small Business Environment

December 4, 2019

Welcome

Brian Goodnough, Office of External Affairs

Disclaimer

One of the benefits of today's session is that you will hear firsthand from numerous PCAOB staff members. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.

Learning Objectives

To discuss important information concerning PCAOB activities with registered public accounting firms that audit the financial statements of public companies operating in the small business community. The webinar features a discussion on the new auditor's report, including critical audit matters; a discussion of recent inspections findings; and a case study focusing on inventory.

Course Description

The PCAOB Small Business Forum webinar is a three hour program that will offer attendees the opportunity to interact with the PCAOB and learn more about its programs and activities, including updates on current activities.

Poll: What does CAM stand for?

1. Critical Accounting Matter
2. Critical Audit Matter
3. Certified Audit Magician
4. Current Audit Matter

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4. Current Audit Matter

Program Evaluation

Your feedback is very important to us. Please take a moment and complete the program evaluation via the link below.

<https://www.surveymonkey.com/r/OEA-SBFwebinar>

Contact the PCAOB

Contact Link

<https://pcaobus.org/About/Pages/Contact.aspx>

General Information

info@pcaobus.org **OR** outreach@pcaobus.org

Standards

(202) 591-4395

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The New Auditor's Report: Critical Audit Matters and Other Current Topics

Lisa Calandriello, Office of the Chief Auditor

Tim Sikes, Division of Registration and Inspections

Poll: What is your level of experience with CAMs?

1. Our firm has large accelerated filer audit clients, and we have reported, or will be reporting on CAMs within the next 12 months.
2. Our firm does not have large accelerated filer audit clients, but we have performed, or will be performing dry runs or pilot tests of CAMs on issuer audit engagements prior to the CAM effective date.
3. Our firm does not plan on doing dry runs or pilot tests of CAMs, but we plan on having discussions early with audit committees about how CAMs may impact the audit report, prior to the CAM effective date.
4. Our firm does not plan on preparatory activities prior to having audit engagements where CAMs will be in effect. Instead, we will deal with CAMs when the time comes to report on CAMs.
5. Our firm does not have any audit clients for which CAM reporting requirements apply.

The New Auditor's Report: Critical Audit Matters and Other Current Topics

Poll: How many large accelerated filers were first impacted by the CAM requirements for June 30, 2019 fiscal year ends?

1. 5
2. 50
3. More than 60

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2. 50

3. More than 60

Poll: For what period are CAMs required to be communicated?

1. Current period only
2. Current and prior periods
3. All periods presented in the F/S

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1. **Current period only**
2. Current and prior periods
3. All periods presented in the F/S

The New Auditor's Report: Critical Audit Matters and Other Current Topics

Poll: Can the auditor take into account factors other than those listed in the standard when determining if a matter is a CAM?

1. Yes
2. No

Poll: Can the auditor take into account factors other than those listed in the standard when determining if a matter is a CAM?

1. Yes

2. No

The New Auditor's Report: Critical Audit Matters and Other Current Topics

Questions



Inspections Overview

Tim Sikes, Division of Registration and Inspections

Inspection Programs Overview



Poll: In 2018, what percentage of inspected firms were non-U.S. firms?

1. 8%
2. 19%
3. 36%
4. 41%

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1. 8%

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3. 36%

4. 41%

Conducting Inspections

- An Inspection consists of reviews of audit work and related quality control systems of registered accounting firms
 - Can be on-site
 - Can be “PCAOB-based”
 - Work papers shipped to PCAOB or accessed via internet portal
 - Interviews by telephone
- Inspector Skillsets/Background
 - Experienced auditors
 - Span major industry groups (e.g., financial services, technology, oil & gas)
 - Wide variety of language skills

Risk-based Inspection



Factors Considered in Risk-Based Selections:

- Economic Trends
- Company or Industry Developments
- Issuer Market Capitalization
- Audit Firm and Audit Partner
- Inspection History

Poll: Of the three Staff Inspection Briefs released in 2018 or 2019, how many have you read?

1. None
2. 1-2
3. All three

PCAOB Inspection Focus

- Auditor's risk assessment process
- Financial reporting and audit areas affected by economic trends and pressures
- Audit areas that present auditing challenges and significant audit risk, including areas of recurring deficiencies, and unpredictable selections
 - Estimating the allowance for loan losses
 - Valuation of acquired assets and financial instruments
 - Revenue recognition
 - Debt and equity related transactions
- Other areas of focus
 - Multinational audits
 - New accounting or auditing standards
 - Information technology systems and reports

Quality Control Areas Reviewed

- Varies based on nature of firm
- Includes:
 - Tone at the Top
 - Client Acceptance and Retention
 - Independence Policies and Procedures
 - Partner Matters
 - Policies, Guidance, and Tools
 - Training
 - Monitoring, such as Internal Inspection Program
 - Response to deficiencies in audit quality

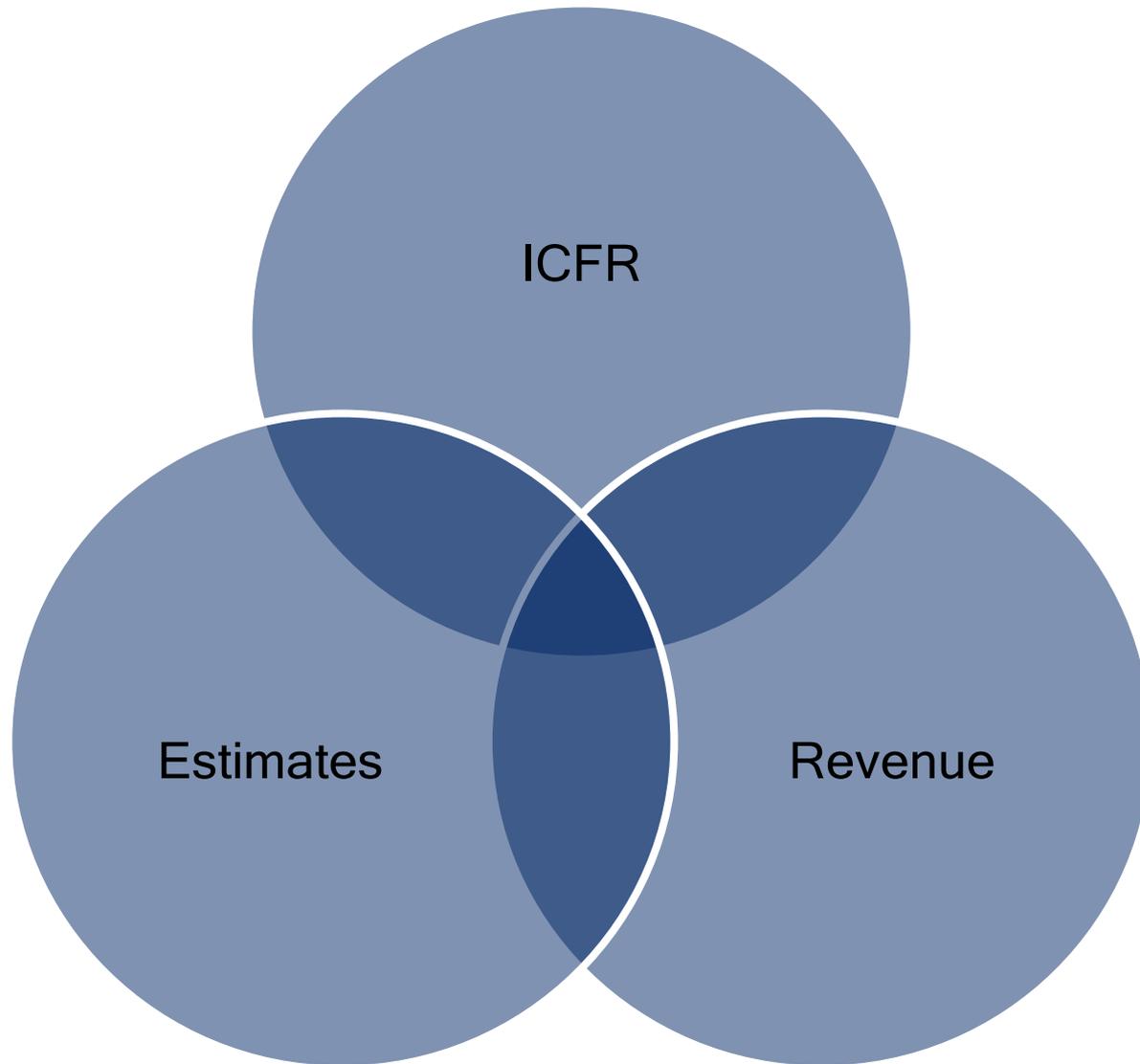
Inspection Process



Inspection Reports

- Inspection reports
 - Do not identify an issuer by name
 - Contain public and may contain nonpublic portions
 - The public portions are posted on the PCAOB's website, including the public portion of firm responses
- Final inspection report triggers a 12-month remediation cycle for any quality control deficiency noted in inspection report
 - These criticisms or potential defects are made public only if they are not satisfactorily addressed by the firm before the 12-month period deadline

Common Findings



Common Findings

- Engagement Quality Review
 - Too much reliance on discussion
 - Limited review to summary memos
 - Experience and Independence

Other Findings

- Form AP filings
- Business Combinations
- Financial Instruments
- Information Provided by the Company

System of Quality Control Findings

- Independence
- Fraud Procedures
- Testing Appropriate to the Audit

Outlook

- System of Quality Control
- Independence
- New Auditing Standards
- Digital Assets
- Upcoming Changes to Inspection Reports

Questions



BREAK (10 minutes)

Case Study: Auditing Inventory

Tim Sikes, Division of Registration and Inspections

Auditing Inventory – Inspection Findings

Issues identified in performing audit procedures related to:

- the use of audit sampling in connection with testing inventory costs
- testing labor and overhead costs capitalized in inventory
- testing the existence of inventory through physical inventory count procedures
- testing the valuation of inventory at the lower of cost or net realizable value
- controls testing related to inventory
- testing the existence of inventory held at third-party warehouses
- testing the company's estimate for its reserve for excess and obsolete inventory

Case Study – Grillstars, Inc.

Case Study – Background

- The Company designs, manufactures, and sells gas and propane grills, pre-fabricated outdoor kitchens, and related accessories to both retailers and consumers.
- During the fiscal year ended June 30, 2019, the Company expanded its presence on the West Coast, along with planned sales incentives.
- This expansion, coupled with strong Q3 and Q4 sales, prompted a significant increase in inventories.
- The Company accounts for and reports its inventory on a first-in, first-out (FIFO) basis.
- The Company's enterprise resource planning ("ERP") system keeps a perpetual inventory record and carries items at standard cost.

Case Study – Background (cont'd)

- Inventory represented approximately 40 percent of total assets as of June 30, 2019.
- The Company's inventory balances as of June 30, 2019 and 2018 consisted of the following:

----- \$ amounts in thousands -----

	June 30, 2019	June 30, 2018
Raw materials	\$11,000	\$ 4,000
Work-in-process ("WIP")	4,000	1,000
Finished goods	26,000	13,000
Reserve for obsolete inventory	<u>(700)</u>	<u>(500)</u>
Total	\$40,300	\$17,500

Case Study – Background (cont'd)

- The Company's inventory is equally dispersed across its three locations: (1) its primary manufacturing center in the Midwest (the "Midwest facility"); (2) a Company-owned distribution facility on the East Coast (the "East Coast facility"); and (3) a new third-party distribution center on the West Coast (the "West Coast facility").



Case Study – Background (cont'd)

- To periodically test its physical inventory quantities, the Company:
 - uses a monthly cycle count approach at its Midwest facility;
 - performs a year-end wall-to-wall count at its East Coast facility; and
 - utilizes and relies upon periodic reports provided by the West Coast facility (a third-party).
- Significant variances (in excess of \$1,000) between perpetual records and physical counts (or third-party records) are required to be investigated by inventory managers.

Case Study – Risk Assessment

- You are the audit engagement partner. Your audit team has made the following risk assessments for the existence and valuation of inventory:

	Inherent Risk	Control Risk	Risk of Material Misstatement	Significant / Fraud Risk?
Existence	Moderate	Low	Low	No
Valuation	High	High	High	Yes

- The low control risk assessment for existence corresponds to the engagement team's plan to test controls relative to the Midwest facility cycle counts, which will reduce the extent of substantive procedures required over existence at that location. Other locations will be tested on a purely substantive basis.
- Because of the significant increase in gross inventory, coupled with the disproportionately smaller increase in the inventory reserve and the Company's planned sales incentives that could reduce selling prices to below cost to promote its West Coast expansion, the engagement team determined that there is a significant risk that inventory might not be carried at the lower of cost or net realizable value (valuation).

Case Study Part 1 – Existence Testing

- You are currently reviewing the internal control and substantive testing procedures performed by your engagement team related to the existence of inventory.
- With respect to inventory held at the Midwest facility, the engagement team has identified and tested certain controls covering the performance of monthly cycle counts in order to support the “low” control risk assessment for the existence assertion.
- The engagement team determined a sample size of three cycle counts (including the June 2019 cycle count) to test the design and operating effectiveness of the inventory cycle count controls.
- In addition to inquiries of the Company’s Controller and Inventory Managers, the engagement team has performed the following procedures to test controls for each of the three monthly cycle counts selected for testing (see next slide):

Case Study Part 1 – Existence Testing (cont'd)

The engagement team's control testing procedures for the Midwest facility:

- Obtained and evaluated the Company's cycle count sheets, which indicated the inventory items counted by the Company and any variances that were identified;
- Verified that the inventory variances from the cycle counts were included in the ERP-generated transaction posting journal ("variance summary report");
- Evaluated the variance summary report to determine that any inventory variances over \$1,000 were investigated by the inventory managers;
- Determined that the count sheets and variance summary report were reviewed and approved by the inventory managers; and
- Obtained the cycle count rolling excel file from the Company, which tracks inventory items counted throughout the year and any variances identified during each cycle count.

Case Study Part 1 – Existence Testing (cont'd)

Substantive procedures performed by the engagement team relative to the existence of inventory included the following:

- Midwest facility – Relied upon the cycle count procedures (i.e. dual-purpose testing approach).
- East Coast facility – Observed the Company's wall-to-wall count procedures, and selected a sample of 40 inventory items (20 floor-to-sheet, and 20 sheet-to-floor) to test count at year end. The sample size was determined assuming no control reliance. No errors were noted in the engagement team's test counts.
- West Coast facility (third-party owned) – Obtained a confirmation letter from the third party to confirm the existence of inventories at year end.
- All locations – Performed shipping and receiving cutoff procedures at year end.

Poll: In general, a well-designed cycle-count program would be expected to result in each item in inventory being counted at least once per year?

1. True
2. False
3. It depends

Poll: In general, a well-designed cycle-count program would be expected to result in each item in inventory being counted at least once per year?

1. True

2. False

3. It depends

Case Study Part 1 – Existence Testing (cont'd)

Question #2 – Discussion Question

- What are your thoughts on the engagement team's procedures over the cycle counts? Do you believe they are sufficient? If not, what other procedures would be necessary to satisfy you?

Case Study Part 1 – Existence Testing (cont'd)

Question #3 – Discussion Question

- Suppose that after testing its cycle count selections, the engagement team concluded that the Company's controls over its Midwest facility cycle count procedures are ineffective, due to the engagement team having identified instances where variances in excess of \$1,000 were not investigated or resolved. What alternative procedures could the engagement team perform in that case?

Poll: Inventory held at the West Coast facility (the third-party facility) accounts for approximately 33 percent of the Company's total inventory and approximately 13 percent of the Company's total assets. Which of the following procedures would you say the auditor should perform in order to obtain reasonable assurance with respect to the existence of the Company's inventory at that facility?

1. Obtain direct confirmation of the Company's inventory quantities held at the third-party warehouse.
2. Obtain an independent accountant's report on the third-party warehouse's control procedures relevant to the custody of the Company's goods, and/or observe physical inventory counts of the Company's goods.
3. None, as long as the auditor obtains significant testing coverage from all other inventory locations tested.
4. 1 and 2

Poll: Inventory held at the West Coast facility (the third-party facility) accounts for approximately 33 percent of the Company's total inventory and approximately 13 percent of the Company's total assets. Which of the following procedures would you say the auditor should perform in order to obtain reasonable assurance with respect to the existence of the Company's inventory at that facility?

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2. Obtain an independent accountant's report on the third-party warehouse's control procedures relevant to the custody of the Company's goods, and/or observe physical inventory counts of the Company's goods.
3. None, as long as the auditor obtains significant testing coverage from all other inventory locations tested.

4. 1 and 2

Case Study Part 2 – Valuation Testing

The following procedures have been proposed by the audit manager as it relates to valuation:

Proposed Audit Approach

Substantive Testing:

- (1) Using the year-end inventory listing, select a sample of inventory items (allocated to raw materials, WIP, and finished goods) and perform FIFO price testing.
 - a. For raw materials selections, obtain and inspect the latest vendor invoices that aggregate to the total quantity on hand at year end, and compare the standard cost per the year-end inventory listing to the actual purchase prices per the invoices.
 - b. For manufactured items included in the sample
 - i. Select the most significant raw materials component and perform the procedure noted in “a.” above.
 - ii. For labor and overhead components, trace standard rates to production data/reports available and assess for reasonableness.
- (2) Select a sample of finished goods items and obtain evidence supporting the latest selling price for that item, and determine whether inventory is stated at the lower of cost or market.
- (3) Perform high-level analytical procedures, such as comparing inventory turnover ratios against previous years.

Case Study Part 2 – Valuation Testing (cont'd)

Question #1 – Discussion Question

- What are your thoughts on the proposed procedures? Are there other procedures you believe should be performed?

Case Study Part 2 – Valuation Testing (cont'd)

Question #2 – Discussion Question

- The audit is now well under way. You are currently reviewing your engagement team's price testing work for the valuation of inventory. Your first step is to review the sample planning form to determine whether your engagement team selected a sufficient number of items to test. In reviewing the sample size calculation in the sample planning form, you notice a significant reduction in the calculated sample size based on an input indicating that extensive other substantive procedures were being performed.
- Based on your review, you have asked the engagement team to explain why such weight was given to other substantive procedures, thereby reducing the required sample size. Your engagement team explains their view that the other substantive procedures, including the analytical procedures and NRV testing, collectively address the valuation assertion; therefore, the engagement team believes it should take credit for those procedures in determining the sample size for price testing.

Case Study Part 2 – Valuation Testing (cont'd)

Question #2 – Discussion Question (cont'd)

- What are your thoughts on the engagement team's response?

Poll: In general, when planning a sample for a substantive test of details, AS 2315, Audit Sampling, indicates that an auditor should consider which of the following:

1. The relationship of the sample to the relevant audit objective
2. Tolerable misstatement
3. The auditor's allowable risk of incorrect acceptance
4. Characteristics of the population
5. The timing of when the audit procedures will be performed
6. All of the above.
7. 1, 2, 3, and 4 above

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1. The relationship of the sample to the relevant audit objective
2. Tolerable misstatement
3. The auditor's allowable risk of incorrect acceptance
4. Characteristics of the population
5. The timing of when the audit procedures will be performed
6. All of the above.
- 7. 1, 2, 3, and 4 above**

Case Study Part 2 – Valuation Testing (cont'd)

Question #4 – Discussion Question

As you continue to review the results of the price testing procedures, you observe that for each WIP and finished good selection, the engagement team has obtained the bill of materials (“BOM”) and performed the following procedures:

- Selected the most significant raw material component of the BOM and performed similar FIFO price test procedures as described in the “Proposed Audit Approach” presented earlier.
- Agreed the labor and overhead rates to a report provided by the Company that summarizes the standard direct labor rates and overhead rates per manufacturing workstation.

What procedures would you recommend your engagement team perform to test the accuracy and completeness of that report?

Poll: In general, as it relates to inventory cost buildup, which of the following costs would you say should be included in inventory?

1. Repairs and maintenance of production equipment
2. Research and development costs
3. Costs of quality control and inspection
4. 1 and 3 above
5. 2 and 3 above

Poll: In general, as it relates to inventory cost buildup, which of the following costs would you say should be included in inventory?

1. Repairs and maintenance of production equipment
2. Research and development costs
3. Costs of quality control and inspection
- 4. 1 and 3 above**
5. 2 and 3 above

Poll: In general, as it relates to fixed overhead production costs, which of the following scenarios is true?

1. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased.
2. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is increased.
3. In periods of abnormally low production, the amount of fixed overhead allocated to each unit of production is increased.
4. 1 and 3 above

Poll: In general, as it relates to fixed overhead production costs, which of the following scenarios is true?

1. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased.
2. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is increased.
3. In periods of abnormally low production, the amount of fixed overhead allocated to each unit of production is increased.
4. 1 and 3 above

Case Study Part 3 – Results of Evaluating Capitalized Variances

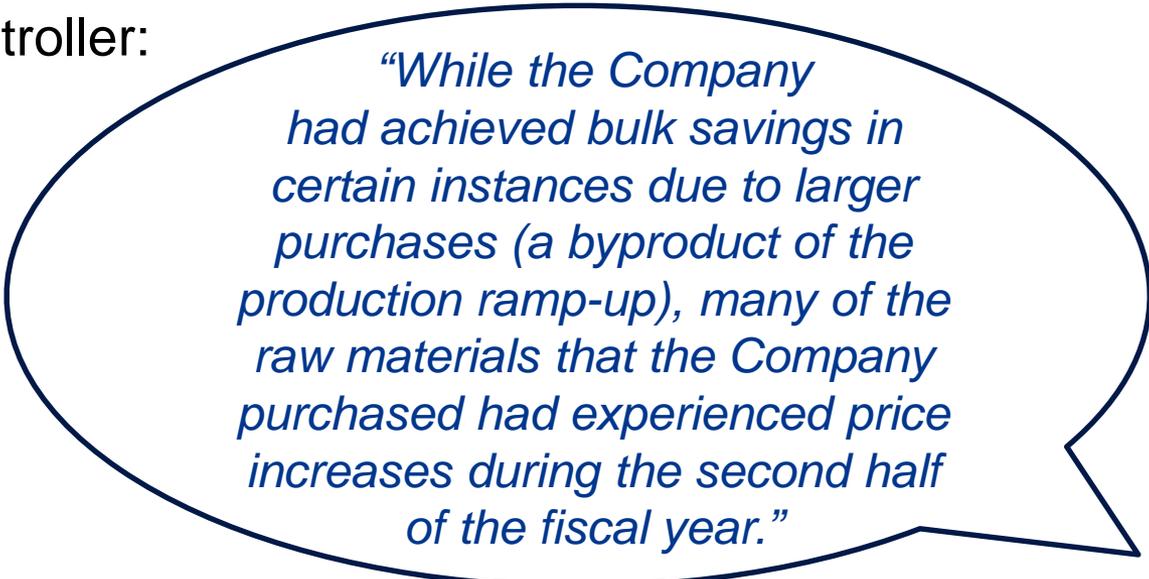
Additional information:

- The Company initially records all variances between standard and actual costs to cost of sales.
- On a quarterly basis, the Company performs an analysis of total inventory variance costs for the period to determine what portion of the variance amount, if any, needs to be capitalized.
- As of June 30, 2019, you observe that the Company has capitalized approximately \$3 million in unfavorable variances, based on the results of its analysis.
- Assume your engagement team determined that tolerable misstatement was \$2 million for this balance.

Case Study Part 3 – Results of Evaluating Capitalized Variances (cont'd)

To evaluate the amount of inventory standard costing variances that were capitalized into inventory, the engagement team's procedures consisted of comparing the amount capitalized at June 30, 2019 to amount capitalized at June 30, 2018 and investigating fluctuations in excess of a certain threshold.

Because the threshold for investigation was triggered, the engagement team inquired with the Controller, and documented the following response from the Controller:



“While the Company had achieved bulk savings in certain instances due to larger purchases (a byproduct of the production ramp-up), many of the raw materials that the Company purchased had experienced price increases during the second half of the fiscal year.”

Poll: Based on the fact pattern provided, what are your thoughts on this procedure?

1. It's fine as is, since the capitalized variances are not significantly higher than tolerable misstatement.
2. The engagement team should evaluate whether the prior year amount is a relevant and appropriate amount to compare to, given the changes in the Company.
3. The engagement team should perform procedures to corroborate the explanation provided by the Controller.
4. 2 and 3 above
5. There may be a better way to analytically test this account.

Poll: Based on the fact pattern provided, what are your thoughts on this procedure?

1. It's fine as is, since the capitalized variances are not significantly higher than tolerable misstatement.
2. The engagement team should evaluate whether the prior year amount is a relevant and appropriate amount to compare to, given the changes in the Company.
3. The engagement team should perform procedures to corroborate the explanation provided by the Controller.
- 4. 2 and 3 above**
- 5. There may be a better way to analytically test this account.**

Case Study Part 4 – Results of Net Realizable Value (“NRV”) Testing

Additional information:

- The engagement team’s approach to test NRV is to utilize the finished good items selected in the price-testing sample discussed earlier.
- Using these selections, as well as a report provided by the Company that indicates sales data by inventory item for the period July 1, 2019 to August 31, 2019, the engagement team:
 - obtained the latest sales invoice for each selection; and
 - compared the selling price per the invoice to the standard cost listed in the year-end inventory listing.
- The engagement team noted no instances where cost was greater than the selling price.

Poll: What are your thoughts on the sample used and the testing approach employed by the engagement team?

1. It's fine as is.
2. The engagement team should test the accuracy and completeness of the sales data report provided by the Company.
3. The engagement team should incorporate selling costs and costs to complete into the selling prices in order to establish NRV.
4. 2 and 3

Poll: What are your thoughts on the sample used and the testing approach employed by the engagement team?

1. It's fine as is.
2. The engagement team should test the accuracy and completeness of the sales data report provided by the Company.
3. The engagement team should incorporate selling costs and costs to complete into the selling prices in order to establish NRV.

4. 2 and 3

Questions



Q&A and Closing Remarks

Program Evaluation

Your feedback is very important to us. Please take a moment and complete the program evaluation via the link below.

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