

# AUDITING AND ASSURANCE SERVICES

AN INTEGRATED APPROACH

ALVIN A. ARENS • RANDAL J. ELDER • MARK S. BEASLEY • CHRIS E. HOGAN

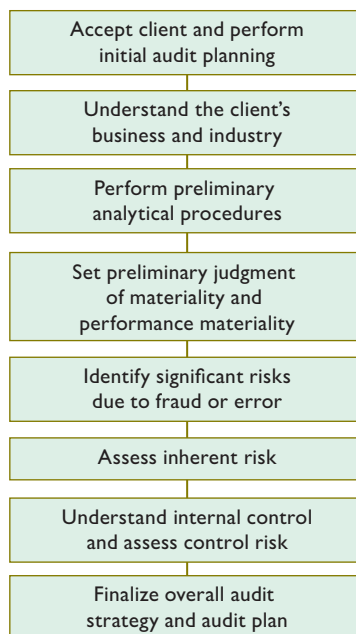


SEVENTEENTH EDITION

## Summary of the Audit Process

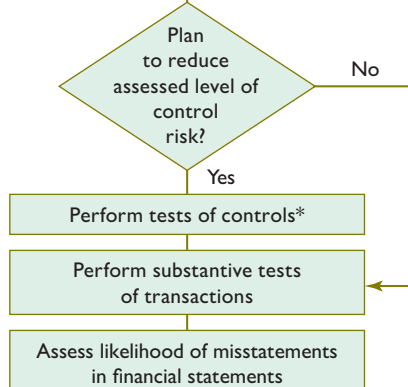
### PHASE I

Plan and design an audit approach



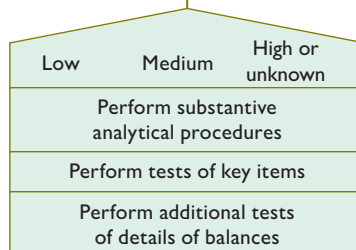
### PHASE II

Perform tests of controls and substantive tests of transactions



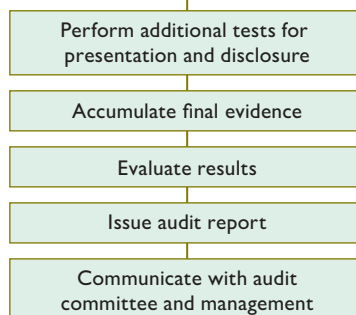
### PHASE III

Perform substantive analytical procedures and tests of details of balances



### PHASE IV

Complete the audit and issue an audit report



\* The extent of tests of controls is determined by planned reliance on controls. For public companies required to have an audit of internal control, testing must be sufficient to issue an opinion on internal control over financial reporting.

# AUDITING AND ASSURANCE SERVICES

**AN INTEGRATED APPROACH**

**SEVENTEENTH EDITION**

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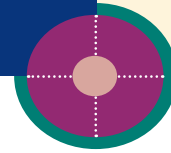
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# CONTINUING THE LEGACY OF ALVIN A. ARENS



**ALVIN A. ARENS:** The author team of Randy Elder, Mark Beasley, and Chris Hogan, are pleased to continue the outstanding legacy of our book's founding author, Al Arens, in this 17th edition of *Auditing and Assurance Services: An Integrated Approach*. As was done for the 15th and 16th editions, we again dedicate this new edition to Al's memory.

Randy and Mark joined Al as coauthors on this textbook in the 8th edition, and have been honored to continue Al's leadership in helping shape classroom instruction and student learning about auditing concepts and their practical implementation around the world. Since the first edition was published, this textbook has impacted audit education for nearly 40 years in the U.S. and globally, including seven different language translations. Al's leadership at national and international levels and his commitment to expanding knowledge through the development of educational materials, including this textbook, continue to inspire us as we strive to advance his legacy for future generations of auditing professionals.

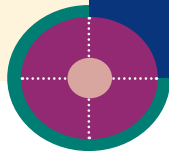


November 24, 1935 — December 6, 2010

Al was the PricewaterhouseCoopers Auditing Professor and member of the Accounting & Information Systems faculty in the Eli Broad College of Business at Michigan State University from 1968 through 2007. Thus, we are especially pleased that Chris Hogan, Professor at Michigan State University, joined the author team in the 16th edition, continuing the Michigan State connection started by Al.

Among his many honors, Al was selected as one of five national auditing educators to hold a Price Waterhouse Auditing professorship, was honored as AICPA Educator of the Year, served on the AICPA Auditing Standards Board, and was President of the American Accounting Association. Al taught accounting, mainly auditing, with a passion that is legendary. He had a heart for sharing his knowledge of auditing with students throughout his career.

This 17th edition continues his outstanding legacy in audit education.



# ABOUT THE AUTHORS

## ALVIN A. ARENS

**Al Arens**, founding author of this textbook, was the PricewaterhouseCoopers Professor of Accounting Emeritus at Michigan State University. In addition to writing books on auditing, he was a coauthor of computerized accounting supplements and he was actively involved in the continuing education of practitioners with local and regional CPA firms. Al was a past president of the American Accounting Association and a former member of the AICPA Auditing Standards Board. He practiced public accounting with both a local CPA firm and the predecessor firm to Ernst & Young. He received many awards including the AAA Auditing Section Outstanding Educator award, the AICPA Outstanding Educator award, the national Beta Alpha Psi Professor of the Year award, and many teaching and other awards at Michigan State.

## RANDAL J. ELDER

**Randy Elder**, who has served as a coauthor of this textbook since the 8th edition, is Dixon Hughes Goodman Professor and Department Head of Accounting and Finance at the University of North Carolina at Greensboro. He teaches undergraduate and graduate auditing courses, and has received several teaching awards. His research focuses on audit quality and current audit firm practices and he served as the team leader for the American Accounting Association Auditing Section PCAOB research synthesis teams on audit confirmations and audit sampling. He has extensive public accounting experience with a large regional CPA firm, frequently teaches continuing education for a large international CPA firm, and is a member of the AICPA.

## MARK S. BEASLEY

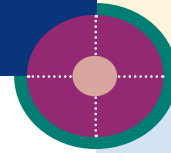
**Mark Beasley**, who has also served as a coauthor of this textbook since the 8th edition, is the Deloitte Professor of Enterprise Risk Management and Professor of Accounting at North Carolina State University. He has taught undergraduate and graduate auditing courses, and has received several teaching awards including membership in NC State's Academy of Outstanding Teachers. He has extensive professional audit experience with the predecessor firm to Ernst & Young and has extensive standards-setting experience working with the Auditing Standards Board as a Technical Manager in the Audit and Assurance Division of the AICPA. He served on the ASB Fraud Standard Task Force responsible for developing SAS 99, the ASB Antifraud Programs and Controls Task Force, and the Advisory Council overseeing the COSO Enterprise Risk Management—Integrated Framework project. He served over seven years as a member of the COSO Board, representing the AAA.

## CHRIS E. HOGAN

**Chris Hogan** joined us as a coauthor starting with the 16th edition. Chris is the Russell E. Palmer Endowed Professor of Accounting and Department Chairperson in the Eli Broad College of Business at Michigan State University. We are thrilled to continue the Michigan State connection started by Al Arens. Chris teaches graduate auditing and her research focuses on internal controls and integrated audits, audit firm client portfolios, and the impact of regulation on audit markets. Chris has auditing experience with Price Waterhouse, one of the predecessor firms to PricewaterhouseCoopers, LLP. She has served in multiple leadership roles within the American Accounting Association, including serving as President of the Auditing Section and on the Audit Committee of the AAA.



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## INTERNAL AND GOVERNMENTAL FINANCIAL AUDITING AND OPERATIONAL AUDITING

CHAPTER

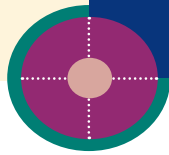
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# PREFACE

The primary emphasis in this text is on the auditor's decision-making process in a financial statement audit, as well as an integrated audit of both financial statements and internal control over financial reporting required for accelerated filer public companies. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

To improve student results, we recommend pairing the text content with **MyLab Accounting**, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates. Learn more at [www.pearson.com/mylab/accounting](http://www.pearson.com/mylab/accounting).

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## NEW TO THIS EDITION

### Current Coverage

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes guidance in the recently issued SAS No. 133, *An Auditor Involvement with Exempt Offering Documents*, and PCAOB standards, including the new standard auditor's report contained in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*. In addition, we have included coverage of the AICPA's Auditing Standards Board pending revision of the auditor's standard unmodified opinion audit report so that our coverage of audit reports is up to date (as discussed further below). It is important to note that as part of this project, the AICPA also revised the management assertions. The changes to the assertions are reflected throughout the text.

Now that the AICPA has completed its Clarity Project for auditing, attestation, and accounting and review services engagements, all chapters of the textbook reflect the various revisions resulting from the issuance of the Clarity standards, including coverage up through the issuance of SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016* and SSAE No. 18, *Attestation Standards: Clarification and Recodification*. We are committed to continually providing you with up-to-date content in this dynamic global auditing environment and will keep you updated with highlights posted on our website of major changes in new standards as they are issued.

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### New Auditor Reports

Both the AICPA's Auditing Standards Board (ASB) and the PCAOB have recently revised guidance related to auditor reporting to make the audit report more informative to users. These changes significantly changed the format and length of content included in the auditor's report. Most notably, auditors of public companies must include in the auditor's standard unmodified opinion report disclosure of "critical audit matters" (CAMs), which represent issues that involved especially challenging, subjective, or complex auditor judgment and how the auditor addressed those matters. While auditors of nonpublic entities are not required to include those disclosures,

the new audit reporting standard proposed by the ASB provides reporting guidance for auditors who are engaged to communicate “key audit matters” (KAMs), which are similar in nature to CAMs in the PCAOB guidance. Chapter 3 provides extensive coverage of these new auditor report guidelines, including a number of illustrations of auditor reports for different engagement circumstances.

The Internet and extensive use of technologies and automation by entities to engage in all types of business transactions and services have dramatically increased the amount of data available for analysis. The audit profession is rapidly exploring how audit data analytics (ADAs) and advanced technologies might allow them to increase both audit quality and efficiency. The 17th edition of this textbook includes new coverage of how ADAs are being used in all phases of the audit, spanning from initial planning through the completion of the audit.

We provide an extensive introduction to ADAs in Chapter 7, including coverage of best practices related to accessing and preparing the data, evaluating the relevance and reliability of that data, addressing large numbers of exceptions for further consideration, and documenting the use of ADAs. We also include coverage of different types of advanced technologies, including artificial intelligence, robotics, machine learning, and deep learning. Additionally, many of the remaining chapters of the textbook include callout “Data Analytics” boxes that highlight different ways auditors are using ADAs in the various financial statement cycles to perform tests of controls, substantive tests of transactions, substantive analytical procedures, and tests of details. These callout boxes help students see how ADAs are transforming the nature, timing, and extent of audit procedures in all aspects of the audit.


To provide students hands-on experience in using various data analytics tools, we have developed an entirely new dataset that includes different files of transaction data related to the sales and collection cycle for a hypothetical company, JA Tire Manufacturing. This dataset, which students can access from the textbook website, includes different sub-files that contain transaction data related to JA Tire Manufacturing’s sales orders, bills of lading, invoices, cash receipts, customer master file, and product master file (an excerpt of a summary of the sub-files is shown below). We have developed several new homework problems included in different chapters that require students to analyze data in the various sub-files of the dataset for JA Tire Manufacturing. Because the dataset is in Excel,

New Coverage of  
Data Analytics and  
Other Advanced  
Technologies

New Dataset for  
Students to Perform  
Audit Data Analytics

JA Tires Sales System Description			
	Process	Relevant File	Fields included
1	JA Tires has four sales divisions: Southeast (SE), Southwest (SW), Midwest (MW) and Northeast (NE)		
2	JA Tires sells various tire products as described in the Product_Master file	Product_Master	Product Number Product Description
3	A Customer Master File is maintained by the Regional Manager	Customer_Master	Customer Number Customer Name Delivery Information Shipping Information Sales Division Territory
4	Customer submits customer order electronically via an online portal. Customers are assigned a customer number that they use to input order through a customer portal. Once logged in, the customer enters the customer Purchase Order # (PO#), Product number and Quantities ordered		
5	A Sales Order is automatically generated in numerical order by the system from the customer order	Sales Order	Sales Order Number Customer Number Customer Purchase Order Number Product Number Price Order Quantity Order Total Sales Order Date Shipping Information Indication of Voided Sales Order

the new homework problems allow students to use any software, such as ACL, Excel, IDEA, or Tableau, to conduct their data analysis. Thus, instructors have the flexibility to choose which software tool they would like students to use to perform the analyses. These problems are indicated by a data analytics icon in the margin next to the problem.

**7-38 (OBJECTIVE 7-5)** As the in-charge senior auditor on the audit engagement for JA Tire Manufacturing for the year ended December 31, 2019, you are responsible for performing risk assessment procedures related to the sales cycle. JA Tire has four sales divisions within the U.S. and sells primarily to large tire companies with regional warehouses that subsequently distribute to local retailers. Based on some of the risk assessment procedures already performed, you identified risks related to the fact that salespersons receive a commission on sales to distributors and the commission is calculated on a monthly basis. Your manager has asked you to perform analytical procedures as a part of audit planning to review sales information by sales division and by month to identify potential risk areas that might warrant further audit procedures related to sales.

**Required**

1. Visit the textbook website to download the file "JATireSales.xls" provided to your audit firm by the company. This file contains sales transaction information for the year ended December 31, 2019. If you have not already done so, read the JA Tire Manufacturing system description provided on the first tab of the Excel file before attempting this assignment to familiarize yourself with the sales process and the relevant worksheets and terminology. Using the "Invoices" and "Sales Order" tabs in the Excel spreadsheet, perform the procedures in requirements 2 through 4 using either Excel, Tableau, or audit software such as ACL or IDEA.

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### Additional Data Analysis Problems

In addition to the new homework problems using the dataset of JA Tire Manufacturing, we have also included a number of other problems in the text that can be completed using Excel templates that are available on the text website. These problems are indicated by a spreadsheet icon in the margin next to the problem. In addition, we have included selected problems using ACL in several chapters in the text, indicated with a data analytics icon. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Guidance for students on the use of ACL is included on the text website.

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### Research Problems to Develop Critical Thinking Skills

Critical thinking and research skills are becoming increasingly important for students as they enter the accounting profession. To help students further develop those skills, we have continued our inclusion of homework problems in the 17th edition that require students to conduct Internet-based research to address various audit issues. Some of those research problems have students work with actual SEC filings by companies, which expose students to relevant examples of audit-related decisions. Other problems require students to conduct research of auditing standards to determine the relevant guidance applicable to a given audit issue.

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### Coverage of Professional Skepticism and Auditor Judgment

With the profession's continued focus on the importance of applying appropriate levels of professional skepticism, we have continued our coverage of this topic in Chapter 6, along with integrated coverage in later chapters, including Chapter 10, which addresses the auditor's responsibilities for detecting fraud. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism.

To assist auditors with maintaining an appropriate level of professional skepticism when making professional judgments during an audit, this edition features the Center for Audit Quality's *Professional Judgment Resource*, which outlines key elements of a process that auditors apply when making professional judgments. Chapter 6 illustrates an effective decision-making process that guides auditors' thinking to help them be aware of their own judgment tendencies, traps, and biases. We include several homework problems that expose students to this judgment framework and a number of the common traps and biases.

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### Coverage on Risk Assessment Procedures and Understanding Internal Control

The requirements of the Sarbanes–Oxley Act of 2002 and the PCAOB Auditing Standard 5 (now AS 2201) that impact accelerated filer public companies are integrated throughout the text and so are the risk assessment standards issued by the Auditing Standards Board. Chapter 2 emphasizes the importance of understanding the client's business and its environment, including internal control. Chapter 3



highlights reporting on internal controls over financial reporting for auditors of accelerated filer public companies.

We have always emphasized understanding the client's business and industry in planning. Chapters 8–12 include coverage of the auditor's performance of risk assessment procedures, including the identification of significant risks. Chapter 9 addresses the performance of risk assessment procedures to address the risk of material misstatement, followed in Chapter 10 with discussion of assessing and responding to the risk of fraud.

Our coverage in Chapters 11 and 12 of internal controls, including coverage of IT general and application controls, reflects key elements of COSO's 2013 revision of its *Internal Control—Integrated Framework* and integrates the auditor's consideration of both manual and automated controls. Chapter 11 introduces students to important elements of effective internal controls, including those related to IT, while Chapter 12 outlines the auditor's responsibilities to understand the design and operating effectiveness of internal control and also highlights auditor reports on internal control over financial reporting. Subsequent chapters that focus on the transaction cycles include extensive coverage of internal controls to help students understand how the auditor's consideration of internal controls is integrated for audits of the financial statements and internal controls over financial reporting.

Chapter 1 introduces the importance of considering international auditing standards developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of International Standards on Auditing (ISAs) and the Auditing Standards Board's efforts to converge U.S. standards to international standards. Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS). Several chapters throughout the book include text or mid-chapter vignette coverage of international issues, and international issues are also addressed in homework problems.

Given the complexity associated with auditing management's assessment of the valuation of certain assets, such as property, plant, and equipment and goodwill, we have expanded our coverage of audit issues related to impairment evaluations. Chapter 19 includes expanded coverage of issues surrounding the facts and circumstances of auditing management's method of determining fair value and whether management has appropriately accounted for and disclosed impairment of those assets. We have included a new vignette in that chapter that specifically addresses the two-step process of conducting a goodwill impairment analysis.

With the increasing volume and complexity of various types of financial instruments and challenges associated with fair value accounting, Chapter 23 addresses issues associated with auditing financial instruments and obtaining sufficient appropriate audit evidence for fair value account estimates. We believe this guidance will help strengthen students' understanding of the challenges associated with auditing financial instruments.

With more organizations taking advantage of cloud computing options and third-party IT service providers, there is a greater need for information about the design and operating effectiveness of internal controls provided by these external service providers. This 17th edition contains coverage of service organization control (SOC) reports issued by service center auditors. Both Chapters 12 and 25 reflect the guidance for service auditors reporting on internal controls at service organizations, including coverage of the different types of reports provided in SOC 1, SOC 2, and SOC 3 engagements.

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**Emphasis on  
International Issues**

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**Expanded Coverage  
of Auditing Asset  
Impairments**

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**Coverage of Financial  
Instruments**

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**Service Organization  
Controls (SOC)  
Reports**

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## Coverage of Preparation Service Engagements

The issuance of SSARS No. 21 introduced a new type of nonattest engagement service that allows nonissuers to engage a CPA to help management prepare monthly, quarterly, or annual financial statements without providing any assurance on the financial statements or issuing a report, even if the financial statements are expected to be used by, or provided to, a third party. Chapter 25 describes this new type of service and distinguishes it from compilation and review engagement requirements.

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## New Opening and Mid-Chapter Vignettes

To help students connect the important auditing concepts to real-world situations, each chapter begins with an opening vignette that illustrates practice issues relevant to that chapter's content, and each chapter includes several short vignettes spread throughout the content of that chapter. Many of these vignettes have been updated to reflect recent real-world events to help students understand the significance of the content covered.

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## Concept Checks

Concept Checks, introduced in the 16th edition, appear periodically within each chapter and highlight short-answer questions to help students recap content covered within different sections of the chapter. These short in-chapter review questions are intended to help call students' attention to key concepts as they read the material in the chapter.

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## New Interactive Concept Check Questions

Linking in the eText will allow students to check their understanding in MyLab Accounting without interrupting their interaction with the eText. These questions are also available for assignment in MyLab Accounting.

The screenshot displays the MyLab Accounting interface. At the top, there is a navigation bar with a hamburger menu, page number 206, and search, bookmark, and font settings icons. Below this, a text block discusses audit documentation characteristics, referencing Figure 7-5 (p. 204). A yellow box labeled 'CONCEPT CHECK' contains two questions: 1. List the purposes of audit documentation and explain why each purpose is important. 2. Explain why it is important for audit documentation to include each of the following: identification of the name of the client, period covered, description of the contents, initials of the preparer and the reviewer, dates of the preparation and review, and an index code. Below the text, a sidebar on the left lists navigation options: My Courses, Course Home, Assignments, Results, Pearson eText (selected), Document Sharing, Multimedia Library, Chapter Resources, and Communication Tools. The main content area shows the Pearson eText interface with a 'View the eText' button and a list of features: Access your eText via smartphones and tablets, Use the text with a screen reader, Configure reading settings, including resizable type and night reading mode, and Take notes, highlight, bookmark, and search. Below this, a section titled 'CC7-5 (book/static)' shows the question: 'List the purposes of audit documentation and explain why each purpose is important.' The question is presented in a table with two columns: 'Purpose' and 'Why Purpose Is Important'. The table has four rows for input. At the bottom, there is a 'Check Answer' button and a 'Clear All' button.

The common characteristics of proper audit documentation preparation are indicated in Figure 7-5 (p. 204).

Auditors often use audit engagement management software to organize and analyze audit documentation. Using audit management software, an auditor can prepare a trial balance, lead schedules, supporting audit documentation, and financial statements, as well as perform ratio analysis. The software also facilitates tracking audit progress by indicating the performance and review status of each audit area. Tick marks and other explanations, such as reviewer notes, can be entered directly into computerized files. In addition, data can be imported and exported to other applications, so auditors may download a client's general ledger or export tax information to a commercial tax preparation package. Auditors also use local area networks and groupshare software programs to access audit documentation simultaneously from remote locations.

**CONCEPT CHECK**

1. List the purposes of audit documentation and explain why each purpose is important.
2. Explain why it is important for audit documentation to include each of the following: identification of the name of the client, period covered, description of the contents, initials of the preparer and the reviewer, dates of the preparation and review, and an index code.

**MyLab Accounting** Pearson eText

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- Use the text with a screen reader
- Configure reading settings, including resizable type and night reading mode
- Take notes, highlight, bookmark, and search

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**CC7-5 (book/static)** [Question Help](#) [Settings](#)

List the purposes of audit documentation and explain why each purpose is important.

Purpose	Why Purpose Is Important
<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>

Choose from any drop-down list and then click Check Answer.

All parts showing   [?](#)

We are excited about the inclusion of a number of changes to the end-of-chapter homework material for all chapters. We have partnered again with Becker CPA Review to include multiple choice problems from their CPA exam preparation materials. These problems, which are included in all 26 chapters, are labeled with the Becker logo. Additionally, each chapter includes new or revised Discussion Questions and Problems that instructors can use in class to generate discussion about important topics addressed in each chapter. These problems are highlighted by an “in-class” discussion icon in the margin next to the related homework problem. Each chapter also identifies homework problems that require students to research standards and other material using the Internet. While many of these research problems expose students to standards, such as those on the PCAOB website, other problems require students to examine recently issued financial statements or other corporate filings or they expose students to best practices thought papers as part of the assignment. Sample problems, assignable in MyAccountingLab, provide an introduction to the CPA Exam format and an opportunity for early practice with CPA exam-style questions.

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### Expanded Homework Material

The annual report for the Hillsburg Hardware Company is included as an insert to the text. Financial statements and other information included in the annual report are used in examples throughout the text to illustrate chapter concepts. The annual report also includes management’s report on internal control as required by the Sarbanes–Oxley Act Section 404a and the auditor’s report required by Section 404b, consistent with PCAOB auditing standards.

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### Hillsburg Hardware Annual Report

The Pinnacle Manufacturing integrated case is based on a large, multi-division company. The case has been revised based on new financial statement data, and it consists of seven parts distributed at the end of each respectively relevant chapter. Each part of the case is designed to give students hands-on experience, and the parts of the case are connected so that students will gain a better understanding of how the parts of the audit are integrated by the audit process.

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### Pinnacle Manufacturing Integrated Case

#### INTEGRATED CASE APPLICATION —

#### PINNACLE MANUFACTURING: PART I

**8-39 (OBJECTIVES 8-3, 8-4)**

##### Introduction

This case study is presented in seven parts. Each part deals largely with the material in the chapter to which that part relates. However, the parts are connected in such a way that in completing all seven, you will gain a better understanding of how the parts of the audit are interrelated and integrated by the audit process. The parts of this case appear in the following textbook chapters:

- Part I—Perform analytical procedures for different phases of the audit, **Chapter 8**.
- Part II—Understand factors influencing risks and the relationship of risks to audit evidence, **Chapter 9**.
- Part III—Conduct fraud brainstorming and assess fraud risks, **Chapter 10**.
- Part IV—Understand internal control and assess control risk for the acquisition and payment cycle, **Chapter 12**.
- Part V—Design tests of controls and substantive tests of transactions, **Chapter 14**.
- Part VI—Determine sample sizes using audit sampling and evaluate results, **Chapter 15**.
- Part VII—Design, perform, and evaluate results for tests of details of balances, **Chapter 16**.

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## SOLVING TEACHING AND LEARNING CHALLENGES

*Auditing and Assurance Services: An Integrated Approach* is an introduction to auditing and other assurance services. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. This book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

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### Integrated Approach for Risk Assessment and Audit Decision Making

As the title of this book reflects, our purpose is to integrate the most important internationally recognized concepts of auditing in a logical manner to assist students in understanding audit decision making and evidence accumulation in today's complex, global auditing environment. For example, developments related to issues affecting auditing in a global and economically volatile environment are described throughout the book and are emphasized in selected mid-chapter vignettes and homework problems. Key concepts related to risk assessment as emphasized in standards issued by the Auditing Standards Board (ASB), the International Auditing and Assurance Standards Board (IAASB), and the Public Company Accounting Oversight Board (PCAOB), including emphasis on significant risks, are integrated into all of the planning chapters, as well as each chapter dealing with a particular transaction cycle and related accounts.

Our coverage of internal control is related to tests of controls and substantive tests of transactions that are performed in a financial statement audit and an integrated audit of financial statements and internal control over financial reporting, with an emphasis on the requirements of PCAOB auditing standards. Tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area. Audit sampling is applied to the evaluation of audit evidence rather than treated as a separate topic. Risk assessment, technology, fraud, and auditing of internal control issues are integrated throughout the chapters.

We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Our objective is to provide up-to-date coverage of globally recognized auditing concepts with practical examples of the implementation of those concepts in real-world settings. The collective experience of the author team in the practice of auditing is extensive. We have all worked in the auditing profession involving both large international audit firms and regional firms. Members of our author team have taught extensively in continuing education for either large international or small CPA firms and have been involved in standards setting activities of the Auditing Standards Board and the PCAOB. One author served over seven years as one of the board members of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These experiences provide unique perspectives about the integration of auditing concepts in real-world settings.

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## TABLE OF CONTENTS OVERVIEW

The text is divided into six parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

**Part I, The Auditing Profession (Chapters 1–5)** The book begins with an opening vignette, featuring a Big 4 public accounting firm's assurance report contained in the Corporate Sustainability Report issued by United Parcel Service (UPS), to help students see the increasingly important role of auditors in providing assurance on a broad range of information important to key stakeholders. Chapter 1 introduces key provisions of the Sarbanes–Oxley Act, including the creation of the PCAOB



and Section 404 internal control reporting requirements. Chapter 2 covers the CPA profession, with particular emphasis on the standards setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the PCAOB and how those responsibilities differ from those of the AICPA Auditing Standards Board (ASB). Chapter 3 provides a detailed discussion of the newly revised audit reports issued under AICPA and PCAOB standards, including communications in the audit report about critical audit matters or key audit matters. Chapter 3 also includes a separate section on the report on internal control over financial reporting for an accelerated filer public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 explains ethical dilemmas, professional ethics, and independence, and it features the recently revised AICPA *Code of Professional Conduct*. Chapter 5 ends this part with an investigation of auditors' legal liability.

**Part 2, The Audit Process (Chapters 6–13)** The first two of these chapters deal with auditor and management responsibilities, professional skepticism, a professional judgment framework for auditor decision-making, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 7 includes extensive coverage of the growing use of audit data analytics (ADAs) and provides best practice guidance to help auditors prepare data for analysis. Chapter 8 deals with planning the engagement, including understanding the company's business and its industry as part of the auditor's risk assessment procedures, using analytical procedures as an audit tool, and making preliminary judgments about materiality. Chapter 9 provides expanded coverage of the auditor's performance of risk assessment procedures used to assess the risk of material misstatement due to fraud or error and how the auditor responds to risks of significant misstatement with further audit procedures. Fraud auditing is the focus of Chapter 10, which builds upon risk assessment concepts covered in the previous chapter to illustrate how risk assessment includes the assessment of fraud risk. The chapter also includes specific examples of fraud and discusses warning signs and procedures performed in response to heightened fraud risk. Chapter 11 outlines the key components of an effective system of internal controls over financial reporting, consistent with the 2013 revision of COSO's *Internal Control—Integrated Framework*. Because most internal control systems are heavily dependent on information technologies, this chapter integrates coverage of IT general controls and application controls. Chapter 12 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements, and it outlines procedures auditors perform as tests of those controls to support a low control risk assessment. The chapter also describes how auditors of accelerated filer public companies integrate evidence to provide a basis for their report on the effectiveness of internal control over financial reporting with the assessment of control risk in the financial statement audit. Chapter 13 summarizes Chapters 6 through 12 and integrates them with the remainder of the text. Several of these chapters include Data Analytics callout boxes that highlight how auditors are incorporating ADAs in all aspects of the audit.

**Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 14–17)** These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts. The appropriate audit procedures for accounts in the sales and collection cycle are related to internal control and audit objectives for tests of controls, substantive tests of transactions, and tests of details of balances in the context of both the audit of financial statements and the audit of internal control over financial reporting.

Students also learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable. Chapter 15 begins with a general discussion of audit sampling for tests of controls and substantive tests of transactions. Similarly, Chapter 17 begins with general sampling concepts for tests of details of balances. The next topic in each chapter is extensive coverage of nonstatistical sampling. The last part of each chapter covers statistical sampling techniques. Several data analytics examples are included in the Data Analytics callout boxes in these chapters.

**Part 4, Application of the Audit Process to Other Cycles (Chapters 18–23)**

Each of these chapters deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 14 through 17 cover the sales and collection cycle. Each chapter in Part 4 demonstrates the relationship of internal controls, tests of controls, and substantive tests of transactions for each broad category of transactions to the related balance sheet and income statement accounts. We integrate discussion of implications related to the audit of internal control throughout all these transaction cycle chapters. Audit issues related to evaluating management's considerations of asset impairment, including goodwill impairment evaluations, are covered in Chapter 19. Cash and financial instruments are studied late in the text to demonstrate how the audit of cash and financial instrument balances is related to most other audit areas.

**Part 5, Completing the Audit (Chapter 24)** This part includes only one chapter, which deals with performing additional tests to address presentation and disclosure objectives, summarizing all audit tests, reviewing audit documentation, obtaining management representations in an integrated audit of financial statements and internal control, evaluating going concern, communicating with those charged with governance, and all other aspects of completing an audit.

**Part 6, Other Assurance and Nonassurance Services (Chapters 25 and 26)** The last two chapters deal with various types of engagements and reports, other than the audit of financial statements using generally accepted accounting principles. Topics covered include assurance services; review, compilation, and preparation services; agreed-upon procedures engagements; attestation engagements; other audit engagements; internal financial auditing; governmental financial auditing; and operational auditing. This edition also includes expanded coverage of service organization control (SOC) reports on internal controls at external service providers.

## INSTRUCTOR TEACHING RESOURCES

Supplements available  
to instructor at

[www.pearsonhighered.com/irc](http://www.pearsonhighered.com/irc)

**Features of the Supplement**

**Instructor's Resource  
Manual**

Suggestions for each chapter include homework problems, how learning objectives correlate with chapter problem material, and visual aids that can be added to PowerPoint slides or used on document cameras or overhead projectors. Chapters have been designed so that their arrangement and selection provide maximum flexibility in course design. Sample syllabi and suggested term projects are provided.

**Solutions Manual**

Included are detailed solutions to all the end-of-chapter exercises, problems, and cases. Guidelines for responses to review questions and discussion questions are offered.



<b>Test Item File &amp; TestGen</b>	The <b>Test Bank</b> , revised by Professor Ronald Premuroso, Online Accounting and Finance Course Instructor and Designer, includes multiple choice exercises, true/false responses, essay questions, and questions related to the chapter vignettes. To assist the instructor in selecting questions for use in examinations and quizzes, each question has been assigned one of three difficulty ratings—easy, medium, or challenging. In addition, questions that uniquely relate to the integrated audits of large public companies or to the provisions of the Sarbanes–Oxley Act and Section 404 have been separately labeled for easy identification by the professor. TestGen testing software is an easy-to-use computerized testing program. It can create exams as well as evaluate and track student results. All Test Item File questions are available in the TestGen format.
<b>PowerPoint Slides</b>	PowerPoint presentations, ADA accessible, and completely revised by Professor Lawrence Chui, University of St. Thomas, PowerPoint presentations are available for each chapter of the text. Instructors have the flexibility to add slides and/or modify the existing slides to meet course needs.
<b>Image Library</b>	The Image Library allows access to most of the images and illustrations featured in the text.
<b>Enhanced Companion Website</b>	Our website provides a wealth of resources for students and faculty. Periodically, faculty will be able to access electronic summaries and PowerPoint slides of the most recent changes to professional standards and summaries of major issues affecting the auditing profession. This will help instructors to stay informed of emerging issues.
<b>Auditing Cases, 7th ed., by Beasley/Buckless/Glover/Prawitt</b>	This collection of 50 auditing cases addresses most major activities performed during the conduct of an audit, from client acceptance to issuance of an audit report. Several cases ask students to work with realistic audit evidence to prepare and evaluate audit schedules. The cases are available as part of Pearson Collections. For details, go to <a href="http://collections.pearsoned.com">collections.pearsoned.com</a> .

## ACKNOWLEDGMENTS

We acknowledge the American Institute of Certified Public Accountants for permission to quote extensively from *Statements on Auditing Standards*, the *Code of Professional Conduct*, *Uniform CPA Examinations*, and other publications. The willingness of this major accounting organization to permit the use of its materials is a significant contribution to the book and audit education.

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David Chan, *St. John's University*

Freddie Choo, *San Francisco State University*

Karl Dahlberg, *Rutgers University*

Frank Daroca, *Loyola Marymount University*

Stephen Del Vecchio, *University of Central Missouri*

Todd DeZoort, <i>University of Alabama–Tuscaloosa</i>	David S. Kerr, <i>University of North Carolina at Charlotte</i>	Kristine N. Palmer, <i>Longwood College</i>
Magdy Farag, <i>California State Polytechnic University, Pomona</i>	William R. Kinney, Jr., <i>University of Texas at Austin</i>	Vicki S. Peden, <i>California State Polytechnic University, Pomona</i>
William L. Felix, <i>University of Arizona</i>	W. Robert Knechel, <i>University of Florida</i>	Ron Reed, <i>University of Northern Colorado</i>
Michele Flint, <i>Daemen College</i>	Jason MacGregor, <i>Baylor University</i>	Pankaj Saksena, <i>Indiana University South Bend</i>
David S. Gelb, <i>Seton Hall University</i>	John Mason, <i>University of Alabama–Tuscaloosa</i>	Cindy Seipel, <i>New Mexico State University</i>
Stephanie Geter, <i>Azusa Pacific</i>	Heidi H. Meier, <i>Cleveland State University</i>	Scott Showalter, <i>North Carolina State University</i>
David Gilbertson, <i>Western Washington University</i>	Alfred R. Michenzi, <i>Loyola College in Maryland</i>	Philip H. Siegel, <i>Troy University</i>
John Giles, <i>Meredith College</i>	Charles R. (Tad) Miller, <i>California Polytechnic State University, San Luis Obispo</i>	Robert R. Tucker, <i>Fordham University</i>
Lori Grady, <i>Bucks County Community College</i>	Lawrence C. Mohrweis, <i>Northern Arizona University</i>	Barb Waddington, <i>Eastern Michigan University</i>
Charles L. Holley, <i>Virginia Commonwealth University</i>	Norma Montague, <i>Wake Forest University</i>	Karl Wang, <i>University of Mississippi</i>
Steve Hunt, <i>Western Illinois University</i>	Curtis Mullis, <i>Georgia State University</i>	Jeanne H. Yamamura, <i>University of Nevada, Reno</i>
Greg Jenkins, <i>Auburn University</i>	Patricia M. Myers, <i>Brock University</i>	Doug Ziegenfuss, <i>Old Dominion University</i>
James Jiambalvo, <i>University of Washington</i>	Kathy O'Donnell, <i>SUNY Buffalo</i>	
Ambrose Jones, III, <i>University of North Carolina–Greensboro</i>		

We especially thank the Pearson book team for their hard work and dedication, including Ellen Geary, acquisitions editor; Gladys Soto, program manager; and Jennifer Gavigan, production project manager at Integra Software Services, Inc.






A. A. A.  
R. J. E.  
M. S. B.  
C. E. H.



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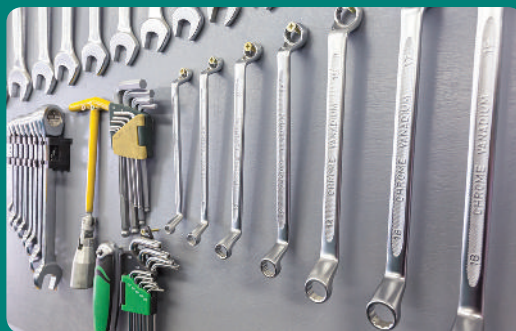
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# 2019 Annual Report



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Rick Chulick, President and Chief Operating Officer

## DEAR SHAREHOLDERS

**March 29, 2020**

We are proud to announce another year of noticeable improvement.

In last year's letter we stated, "We are committed to increasing the efficiency and effectiveness of operations through cost savings and productivity improvements, in light of current economic conditions. In addition, we intend to maintain and further develop our customer base through recently implemented post-sale service programs." The operating results in this report demonstrate that our objectives have been achieved, resulting in a net income increase of \$740,000 from 2018 to 2019. This amounts to 15 cents per share, a 23.2% increase from last year. Our goal in the current year is to further improve the results of operations and create value for shareholders. In doing so, we will focus primarily on the following three strategic components of our business plan:

1. Post-sale service arrangements designed to further develop and maintain our customer base.
2. Aggressive advertising campaigns that allow us to penetrate markets dominated by national wholesale hardware store chains.
3. Implementation of new warehouse technology designed to increase productivity and reduce stocking and distribution costs.

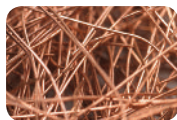
We will report our progress throughout the year.

A stylized, handwritten signature in black ink, appearing to read "C. Kurran".

Christopher J. Kurran  
Chief Executive Officer

A stylized, handwritten signature in black ink, appearing to read "R. Chulick".

Rick Chulick  
President and Chief Operating Officer



## History

Hillsburg Stores Inc. began operations in 1990 in Gary, Indiana, as a retail hardware store chain. On September 25, 1996, Hillsburg merged with Handy Hardware and Lumber Company, which established the concept of selling high-quality hardware through wholesale distribution outlets, to form Handy-Hillsburg, Inc., a Washington corporation. On June 5, 2000, after spinning off all of its lumber-related assets to Handy Corporation, the company changed its name to Hillsburg Hardware, Inc. On October 22, 2002, the company reincorporated from Washington to Delaware and changed its name to Hillsburg Hardware Company (hereafter referred to as “the Company”), which trades on the NASDAQ under the symbol “HLSB.”

## Overview

Hillsburg Hardware Company is a wholesale distributor of hardware equipment to a variety of independent, high-quality hardware stores in the midwestern part of the United States. The primary products are power and hand tools, landscaping equipment, electrical equipment, residential and commercial construction equipment, and a wide selection of paint products.

More than 90% of the Company’s products are purchased from manufacturers and shipped either directly to customers or to the main warehouse in Gary, Indiana, where shipments are combined to minimize the costs of freight and handling.

Hardware retailers, now more than ever, find it advantageous to purchase from us rather than directly from manufacturers. We make it possible for smaller, independent retailers to purchase on an as-needed basis, rather than in bulk. Moreover, we offer our customers a range of high-quality products that cannot be found at most national chains.

We also offer far more post-sale services to customers than are offered by manufacturers and other national distributors. We simplify the purchasing process by assigning each customer a permanent salesperson. Each salesperson becomes involved

in the sales process, and also acts as a liaison between the customer and post-sale service areas. For example, when customers experience technical problems with recently purchased hardware, their salesperson has the responsibility to coordinate both exchanges and warranty repairs with the manufacturer. This process adds value for customers and makes post-sales service more efficient and less problematic. Low turnover and extensive training of our salespeople enhance this service.

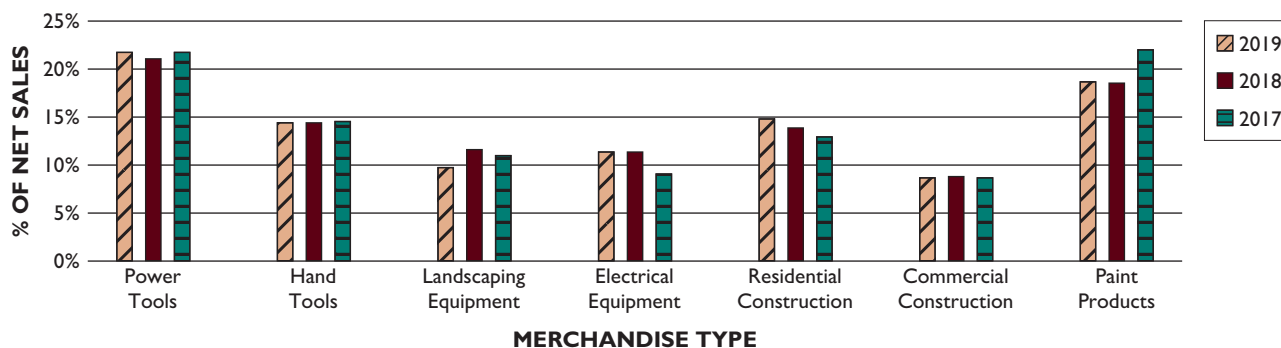
To further encourage customer loyalty, each customer is given access to our internal database system—ONHAND (Online Niche-Hardware Availability Notification Database). The ONHAND system lets customers check the availability of hard-to-find products instantly over the Internet. Moreover, the system includes data such as expected restock dates for items that are currently sold out and expected availability dates for items that will soon be introduced to the market.

Because of the two aforementioned processes, we have managed to maintain a repeat-customer base. Nearly 75% of all first-time customers make at least one additional purchase within one year of their first purchase.

Recently, there have been major consolidations in the wholesale hardware industry. We believe this consolidation trend is advantageous to our operations as a distributor of hard-to-find, high-quality hardware equipment. The recent consolidation of Builder’s Plus Hardware, Inc., one of the top ten largest national hardware store chains, is a case in point. One month after the consolidation, Builder’s Plus decided not to carry high-end construction and landscaping equipment in order to focus on what it called the “typical hardware customer.”

## Products

To more effectively manage inventory, we carefully monitor the composition of net sales by category of items sold. The following chart indicates the percentage of net sales by class of merchandise sold during the years 2019, 2018, and 2017:





**Marketing Program**

This year, the Company made a significant investment in a new advertising campaign. Various Internet, radio, newspaper, magazine, and television advertisements were purchased at the local and regional levels using the Company’s new catchphrase, “Hardware for Hard Workers.” The new jingle has been partially responsible for the fiscal 2019 increase in sales of 9%.

**Customers**

The majority of our customers are located in Illinois, Michigan, Wisconsin, Ohio, and Missouri. Our current customer base consists of more than 400 independently owned hardware stores. Approximately 25% of our customers make up more than 80% of total sales revenue. To promote long-standing relationships with customers, we offer an array of incentive and customer appreciation programs. Since these programs were implemented in 2010, customer satisfaction ratings have improved steadily in each subsequent year.

**Suppliers**

We purchase hardware and other products from more than 300 manufacturers in the United States. No single vendor accounted for more than 5% of our purchases during fiscal 2019, but our 25 largest vendors accounted for nearly 35%. We currently have long-term supply agreements with two vendors: Mechanical Tools and Painter’s Paradise. These agreements are in effect until the end of fiscal year 2020. The combined dollar amount of each contract is not expected to exceed 5% of total purchases for the year.

**Competitors**

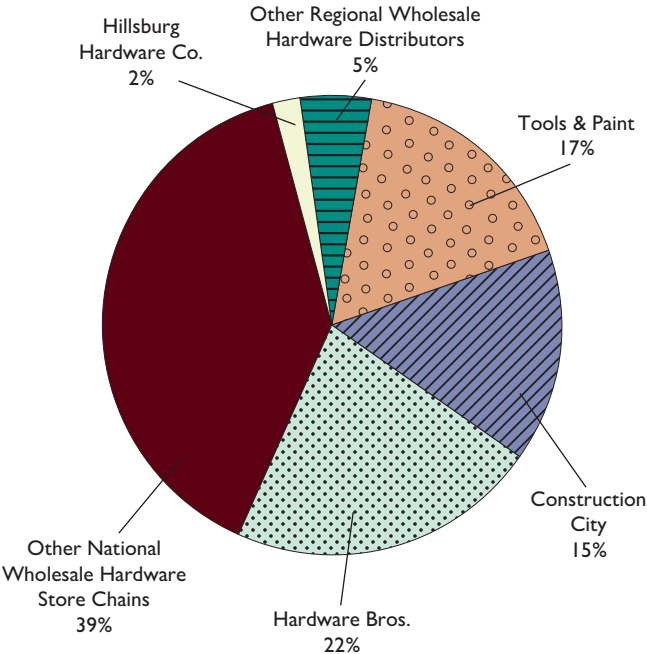
There are other regional wholesale hardware distributors that compete with the Company, but national wholesale hardware store chains dominate the industry. Most of our competitors are not only larger, but have greater financial resources than our company. Ten national chains exist in the geographic area in which Hillsburg Hardware Co. operates. Of the ten national chains, Hardware Bros., Tools & Paint, and Construction City account for a significant portion of the wholesale hardware market share and also carry the hard-to-find and high-quality items we provide. The success of our business depends on our ability to keep distribution costs to a minimum and our customers satisfied through superior customer service.









The chart below is a breakdown of market share in the wholesale hardware market by competitor category, including the 2% market share held by the Company. The chart illustrates that we have considerable opportunity for sales growth.



**Employees**

Hillsburg Hardware currently employs 319 individuals. The majority of our employees are involved in day-to-day sales. Because of our marketing and customer relations strategy, we make significant investments in ongoing training and professional development activities. Each year employees are required to attend 75 hours of professional training. Each employee receives a performance evaluation at least four times per year, usually once each quarter. Our turnover is among the lowest in the industry because of our compensation, training, and evaluation programs. We regard our employees as our most valuable asset.



	NAME	AGE	POSITION
	John P. Higgins	55	Chairman of the Board
	Christopher J. Kurran	47	Chief Executive Officer (b)
	Rick Chulick	48	President and Chief Operating Officer (a)
	Avis A. Zomer	44	Chief Financial Officer
	Brandon S. Mack	51	Vice President Sales and Marketing
	Mary R. Moses	36	Vice President Merchandising
	Vanessa M. Namie	53	Vice President Operations (c)
	Joseph A. Akins	64	Vice President Quality Assurance (d)

(a) Mr. Chulick has been President and Chief Operating Officer of the Company since November 2009.

(b) Mr. Kurran has been Chief Executive Officer of the Company since September 2009. Prior to his role as CEO, Mr. Kurran was employed from 2000–2008 by Trini Enterprises, an industrial distributor.

(c) Ms. Namie has been employed by the company since its inception in 2002. She has held her current position since 2008 and served as an operations manager from 2002–2008.

(d) Mr. Akins was Chief Operating Officer and President of Hardware Bros., one of the ten largest wholesale hardware chains in the nation, from 2006–2011.

## Properties

The Company owns and operates its main warehouse and an administrative office. The main warehouse and administrative office are in the same 475,000 square-foot building. We also rent a second warehouse for which rental fees are \$312,000 annually. The building, located in Detroit, Michigan, serves as an off-site storage facility.

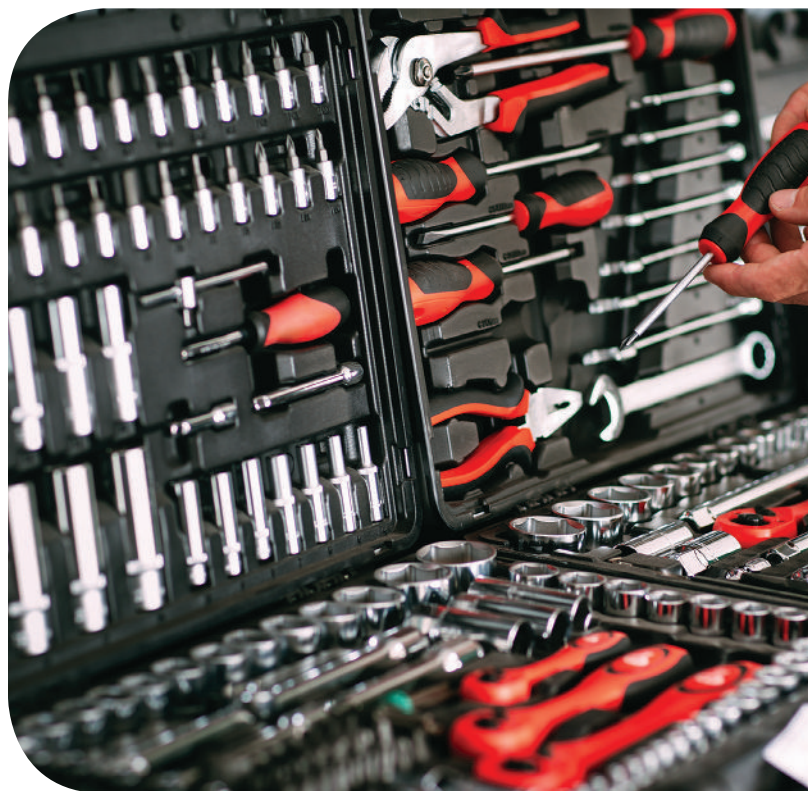
## Legal Proceedings

On September 3, 2018, a suit was filed in the Circuit Court in Gary, Indiana, against the Company. The product liability suit, “*Don Richards v. Hillsburg Hardware Co.*” is related to injuries that resulted from an alleged defective design of a tractor manufactured by Silo-Tractor, a U.S. corporation. The suit is currently in pretrial proceedings. In the opinion of our legal counsel the suit is without merit. We intend to vigorously defend our position.

The Company does not believe any other legal issues materially affect its finances.

## Executive Officers

The following list provides names, ages, and present positions of the Company’s officers:



“We offer our customers a range of high-quality products that cannot be found at most national chains.”



### Controls and Procedures

Pursuant to Section 404 of the Sarbanes–Oxley Act of 2002 and related Exchange Act Rules, we have carefully evaluated the design and operating effectiveness of our internal control over financial reporting. After careful review of all key controls over financial reporting, our Chief Executive Officer and Chief Financial Officer implemented new controls to strengthen processes surrounding revenue recognition. In compliance with Section 404 and related Exchange requirements, management has issued its report that internal controls over financial reporting are operating effectively as of December 31, 2019 based on criteria established in the *COSO Internal Control-Integrated Framework (2013)*.

### Information Regarding Common Equity

Hillsburg Hardware Company's common stock currently trades on the NASDAQ under the symbol "HLSB." The following chart shows the high and low prices of the Company's common stock by quarter for the years 2019 and 2018:

	2019		2018	
	HIGH	LOW	HIGH	LOW
Quarter 1	22.50	19.05	23.30	20.00
Quarter 2	22.55	20.10	22.75	20.25
Quarter 3	22.30	20.99	24.10	19.75
Quarter 4	22.40	17.95	21.50	18.20

On March 23, 2020, there were 1,250 shareholders of our common stock.

### Dividend Policy

Dividend payments on common stock are authorized annually by the Board of Directors. For 2019, dividend payments totaled \$1.9 million, which is \$.38 per share.



# REPORT OF INDEPENDENT REGISTERED ACCOUNTING FIRM

## Board of Directors and Stockholders Hillsburg Hardware Company

### Opinion on the Financial Statements and Internal Control Over Financial Reporting

We have audited the accompanying balances sheets of Hillsburg Hardware Company, Inc. (the Company) as of December 31, 2019 and 2018, the related statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2019, and the related notes (collectively referred to as the "financial statements"). We have also audited the Company's internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by COSO.

### Basis for Opinions

The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying report, Management's Responsibility for the Financial Statements. Our responsibility is to express an opinion on the Company's financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

### Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

### **Critical Audit Matters**

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

### **Valuation of inventory**

Given the materiality of inventory in relation to total assets and the judgment involved in determining realizable value, inventory valuation is considered a significant risk. Inventory is presented at the lower of average cost or net realizable value. There is an element of judgment related to determining net realizable values which are based on historical evidence, product trends, the availability of competing products, and current economic conditions. Changing trends and the economic environment require judgment to be reassessed at each reporting date.

Inventory balances of \$29,865 and \$31,600 (in thousands) as of December 31, 2019 and December 31, 2018, respectively, are included in the balance sheet. The method of accounting for inventory is disclosed in footnote 1 to the financial statements.

We performed testing of the operating effectiveness of key controls around the realizable value of inventory. We evaluated products for obsolescence as part of our physical inventory observation procedures. We considered the inventory provision for obsolescence and items to be sold at less than cost by evaluating inventory and sales data by product, management's forecasts for product demand, and product prices subsequent to year-end.

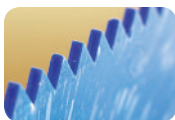
*Berger & Anthony, LLP*

Berger and Anthony, LLP

We have served as the Company's auditor since 2002.

Gary, Indiana

March 21, 2020



## Management's Responsibility for the Financial Statements To Our Shareholders:

The accompanying financial statements of Hillsburg Hardware Company have been prepared by management, which is responsible for their integrity and objectivity. The statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management has also prepared information elsewhere in this Annual Report that is consistent with data in the financial statements. The Company's financial statements have been audited by Berger and Anthony, independent Certified Public Accountants. Our auditors were given unrestricted access to all financial records and related data, including minutes of the meetings of the Board of Directors. We believe all representations made to Berger and Anthony were legitimate and appropriate.

The management of Hillsburg Hardware Company is responsible for establishing and maintaining adequate internal control over financial reporting. Hillsburg Hardware Company's internal control system was designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.

Hillsburg Hardware Company management assessed the effectiveness of the company's internal control over financial reporting as of December 31, 2019. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework (2013)*. Based on our assessment we believe that, as of December 31, 2019, the company's internal control over financial reporting is effective based on those criteria.

Hillsburg Hardware Company's independent auditors have issued an audit report on our financial statements and internal control over financial reporting. This report appears on the preceding two pages.

John P. Higgins  
Chairman of the Board

Christopher J. Kurran  
Chief Executive Officer

Avis A. Zomer  
Chief Financial Officer



## Hillsburg Hardware Company

### Balance Sheets (in thousands)

	December 31	
<b>ASSETS</b>	<b>2019</b>	<b>2018</b>
<b>Current assets</b>		
Cash and cash equivalents	\$ 828	\$ 743
Trade receivables (net of allowances of \$1,240 and \$1,311)	18,957	16,210
Other receivables	945	915
Merchandise inventory	29,865	31,600
Prepaid expenses	432	427
Total current assets	51,027	49,895
<b>Property and equipment</b>		
Land	3,456	3,456
Buildings	32,500	32,000
Equipment, furniture, and fixtures	6,304	8,660
Less: accumulated depreciation	(31,920)	(33,220)
Total property and equipment (net)	10,340	10,896
<b>Total assets</b>	<b>\$ 61,367</b>	<b>\$ 60,791</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Trade accounts payable	\$ 4,720	\$ 4,432
Notes payable	4,180	4,589
Accrued payroll	1,350	715
Accrued payroll tax	120	116
Accrued interest and dividends payable	2,050	1,975
Accrued income tax	796	523
Total current liabilities	13,216	12,350
<b>Long-term notes payable</b>	24,120	26,520
<b>Deferred income taxes</b>	738	722
<b>Other long-term payables</b>	830	770
<b>STOCKHOLDERS' EQUITY</b>		
Capital stock (\$1 par value; 5,000,000 shares issued)	5,000	5,000
Capital in excess of par value	3,500	3,500
Retained earnings	13,963	11,929
<b>Total stockholders' equity:</b>	<b>22,463</b>	<b>20,429</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 61,367</b>	<b>\$ 60,791</b>

See Notes to Financial Statements.

## Hillsburg Hardware Company

### Statement of Operations (in thousands)

Year Ended December 31

	2019	2018	2017
Net sales	\$ 143,086	\$ 131,226	\$ 122,685
Cost of sales	103,241	94,876	88,724
Gross profit	39,845	36,350	33,961
Selling, general and administrative expenses	32,475	29,656	28,437
Operating income	7,370	6,694	5,524
Other income and expense			
Interest expense	2,409	2,035	2,173
Gain on sale of assets	(720)	—	—
Total other income/expense (net)	1,689	2,035	2,173
Earnings before income taxes	5,681	4,659	3,351
Provision for income taxes	1,747	1,465	1,072
Net income	\$ 3,934	\$ 3,194	\$ 2,279
Earnings per share	\$ 0.79	\$ 0.64	\$ 0.46

See Notes to Financial Statements.



## Hillsburg Hardware Company

### Statement of Stockholders' Equity (in thousands)

	Common Stock Shares	Common Stock Par value	Paid-in Capital	Retained Earnings	Total Stockholders' Equity
<b>Balance as of December 31, 2016</b>	<b>5,000</b>	<b>\$ 5,000</b>	<b>\$ 3,500</b>	<b>\$ 10,256</b>	<b>\$ 18,756</b>
Net income				2,279	2,279
Dividends paid				(1,900)	(1,900)
<b>Balance as of December 31, 2017</b>	<b>5,000</b>	<b>\$ 5,000</b>	<b>\$ 3,500</b>	<b>\$ 10,635</b>	<b>\$ 19,135</b>
Net income				3,194	3,194
Dividends paid				(1,900)	(1,900)
<b>Balance as of December 31, 2018</b>	<b>5,000</b>	<b>\$ 5,000</b>	<b>\$ 3,500</b>	<b>\$ 11,929</b>	<b>\$ 20,429</b>
Net income				3,934	3,934
Dividends paid				(1,900)	(1,900)
<b>Balance as of December 31, 2019</b>	<b>5,000</b>	<b>\$ 5,000</b>	<b>\$ 3,500</b>	<b>\$ 13,963</b>	<b>\$ 22,463</b>

See Notes to Financial Statements.

## Hillsburg Hardware Company

### Statement of Cash Flows (in thousands)

Year Ended December 31

<b>OPERATING ACTIVITIES</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Net income	\$ 3,934	\$ 3,194	\$ 2,279
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,452	1,443	1,505
(Gain) or Loss on sale of assets	(720)	—	—
Deferred income taxes increase (decrease)	16	(8)	43
Changes in assets and liabilities:			
Trade and other receivables	(2,777)	(393)	(918)
Merchandise inventory	1,735	(295)	(430)
Prepaid expenses	(5)	(27)	(55)
Accounts payable	288	132	76
Accrued liabilities	714	77	142
Income taxes payable	273	23	13
Net cash provided by operating activities	4,910	4,146	2,655
<b>INVESTING ACTIVITIES</b>			
Capital expenditures	(10,500)	(1,800)	(2,292)
Sale of equipment	10,324	—	—
Net cash used in investing activities	(176)	(1,800)	(2,292)
<b>FINANCING ACTIVITIES</b>			
Dividend payment	(1,900)	(1,900)	(1,900)
Proceeds (repayments) from borrowings (net)	(2,749)	(423)	1,602
Net cash used in financing activities	(4,649)	(2,323)	(298)
<b>Net increase in cash and cash equivalents</b>	85	23	65
<b>Cash and cash equivalents at beginning of year</b>	743	720	655
<b>Cash and cash equivalents at end of year</b>	\$ 828	\$ 743	\$ 720

See Notes to Financial Statements.



## 1. Description of Significant Accounting Policies and Business

Hillsburg Hardware is a wholesale distributor of high-quality power tools, hand tools, electrical equipment, landscaping equipment, residential and commercial construction equipment, and paint products. The majority of customers are smaller, independent hardware stores located in Illinois, Michigan, Wisconsin, Ohio, and Missouri.

**Allowance for Doubtful Accounts:** The allowance for doubtful accounts is maintained to account for expected credit losses. Estimates of bad debts are based on individual customer risks and historical collection trends. Allowances are evaluated and updated when conditions occur that give rise to collection issues.

**Merchandise Inventory:** Merchandise inventory is presented at the lower of average cost or market. To present accurately the estimated net realizable value of the accounts, inventory balances are adjusted when current and expected future market conditions, as well as recent and historical turnover trends, indicate adjustments are necessary.

**Property, Plant and Equipment:** Land, buildings, computers and other equipment, and furniture and fixtures are stated at historical cost. Depreciation is calculated on a straight-line basis over estimated useful lives of the assets. Estimated useful lives are 20 to 35 years for buildings and 2 to 10 years for equipment and furniture and fixtures.

**Revenue Recognition:** Revenues are recognized when goods are shipped, title has passed, the sales price is fixed, and collectibility is reasonably assured. A sales returns and allowance account is maintained to reflect estimated future returns and allowances. Adjustments to the sales returns and allowance account are made in the same period as the related sales are recorded and are based on historical trends, as well as analyses of other relevant factors. Sales are recorded net of returns and allowances in the statements referred to in this report.

**Income Taxes:** The deferred income tax account includes temporary differences between book (financial accounting) income and taxable income (for IRS reporting purposes). The account consists largely of temporary differences related to (1) the valuation of inventory, (2) depreciation, and (3) other accruals.

## 2. Other Receivables

The other receivables balance consists largely of vendor allowances and vendor rebates. When vendor allowances and vendor rebates are recognized (all activities required by the supplier are completed, the amount is determinable, and collectibility is reasonably certain), they are recorded as reductions of costs of goods sold.

## 3. Notes Payable

Notes payable for the year ended December 31, 2019, consists of three notes payable to the bank. Each note carries a fixed

interest rate of 8.5%. One note for \$4,180,000 matures in June 2020 and the other two mature on December 31, 2022. During 2019, there was an additional note outstanding in the amount of \$4,400,000, which was paid off during October 2019.

## 4. Segment Reporting

The Company operates in one segment. The breakdown of revenues (in thousands) from different products is listed in the chart below:

### SEGMENT REPORTING

	2019	2018	2017
<b>Power Tools</b>	\$ 31,479	\$ 27,557	\$ 26,991
<b>Hand Tools</b>	21,463	19,684	18,403
<b>Landscaping Equipment</b>	14,309	15,645	13,494
<b>Electrical Goods</b>	17,170	15,849	11,042
<b>Residential</b>			
<b>Construction Equipment</b>	21,463	18,372	15,949
<b>Commercial</b>			
<b>Construction Equipment</b>	11,447	10,498	9,815
<b>Paint Products</b>	25,755	23,621	26,991
	<b>\$143,086</b>	<b>\$131,226</b>	<b>\$122,685</b>

## 5. Earnings Per Share

Earnings per share calculations for 2019, 2018, and 2017 were computed as follows:

### Numerators

(net income in thousands): \$3,934, \$3,194, and \$2,279

### Denominators

(shares of common stock): 5,000,000 (unchanged for all years)

Diluted earnings per share was the same as basic earnings per share for all years.



## Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the results of our operations and our financial condition are based on the financial statements and related notes included in this report. When preparing the financial statements, we are frequently required to use our best estimates and judgments. These estimates and judgments affect certain asset, liability, revenue, and expense account balances. Therefore, estimates are evaluated constantly based on our analyses of historical trends and our understanding of the general business environment in which we operate. There are times, however, when different circumstances and assumptions cause actual results to differ from those expected when judgments were originally made. The accounting policies referred to in Note 1 to the financial statements, in our opinion, influence the judgments and estimates we use to prepare our financial statements.

### Results of Operations

For the year ended December 31, 2019, gross profit increased by 9.6% or \$3,495,000 from 2018. This increase in gross profit more than offsets the increase in operating expenses from 2018 to 2019 of \$2,819,000 or 9.5%. The increase in gross margin largely explains the operating income increase of \$676,000.

For the year ended December 31, 2018, gross profit increased by \$2,389,000 or 7% from 2017. Total operating expenses increased by \$1,219,000 or approximately 4.3% from 2017. The increase in gross profit offset the total operating expense increase, and the net result was a \$1,170,000 increase in operating income.

**Net Sales:** From 2018 to 2019 net sales increased by \$11,860,000 or 9%. The increase in net sales can be explained largely by an aggressive advertising campaign that the Company organized during the second half of 2019. Net sales for 2018 increased by \$8,541,000 or 7.0% from 2017, which is consistent with industrywide average revenue growth of 7% from 2017 to 2018.

**Gross Profit:** Gross profit as a percentage of net sales stayed relatively stable at 27.68% and 27.70% in 2017 and 2018, respectively, but increased to 27.85% in 2019. The 2019 increase is mostly due to improved vendor incentive programs, our focus on cost containment, and increases in the resale values of certain commodities such as PVC piping material and certain types of metal wiring. While gross profit percentages in the industry have declined somewhat, our position as a niche provider in the overall hardware market allows us to charge premium prices without losing customers.

**Selling, General, and Administrative Expenses:** Selling expenses increased by \$1,911,000 or 14.8% from 2018 to 2019 and by \$805,000 or 6.7% from 2017 to 2018. As a percentage of net sales, selling expenses increased by 0.52% since 2018 and decreased by 0.03% from 2017 to 2018. The increase in selling expenses as a percentage of net sales

from 2018 to 2019 is due to our new advertising campaign and increased expenditures on sales meetings and training.

General and administrative expenses increased by \$908,000 or 5.4% from 2018 to 2019 and by \$414,000 or 2.5% from 2017 to 2018. As a percentage of net sales, general and administrative expenses decreased by 0.42% since 2018 and decreased by 0.55% from 2017 to 2018. The overall increase from 2018 to 2019 was caused mostly by unexpected repairs needed to reattach and replace damaged shelving units in our main warehouse building.

**Interest Expense:** In 2019, interest expense increased by \$374,000, or approximately 18.4%, compared to 2018. The increase was due to an overall interest rate increase and the restructuring of debt covenants that are less restrictive but demand higher interest rates. In 2018 interest expense decreased by \$138,000 or 6.4% compared to 2017. The 2018 decrease was mainly due to the Company's decision to decrease the level of long-term debt. The average interest rates on short- and long-term debt during 2019 were approximately 10.5% and 8.5% respectively.

### Liquidity

During 2019, our working capital requirements were primarily financed through our line of credit, under which we are permitted to borrow up to the lesser of \$7,000,000 or 75% of accounts receivable outstanding less than 30 days. The average interest rate on these short-term borrowings in 2019 was approximately 10.5%.

Cash provided by operating activities for 2019 and 2018 was \$4,910,000 and \$4,146,000 respectively. The change from 2018 to 2019 is primarily due to the increase in net income. Increases in receivables were largely offset by decreases in inventories and increases in payables and other current liabilities. The increase in cash provided from operating activities of \$1,491,000 from 2017 to 2018 is largely the result of the increase in net income and smaller increases in receivables and merchandise inventory in 2018 compared to 2017. We believe that cash flow from operations and the available short-term line of credit will continue to allow us to finance operations throughout the current year.

### Statement of Condition

Merchandise inventory and trade accounts receivable together accounted for over 95% of current assets in both 2019 and 2018. Merchandise inventory turned over approximately 3.4 times in 2019 and 3.0 times in 2018. Average days to sell inventory were 108.6 and 120.9 in 2019 and 2018 respectively. Net trade receivables turned over approximately 7.6 times in 2019 and in 2018. Days to collect accounts receivable computations were 48.1 and 48.0 in 2019 and 2018 respectively. Both inventory and accounts receivable turnover are lower than industry averages. We plan for this difference to satisfy the market in which we operate. Our market consists of smaller, independent hardware stores that need more favorable receivable collection terms and immediate delivery of inventory. Because we hold large amounts of inventory, we are able to fill orders quicker than most of our competitors even during the busiest times of the year.



## Outlook

During 2019 we experienced another year of noticeable improvement, despite the economic environment. The Company's financial performance can largely be attributed to (1) a continued focus on cost containment, (2) productivity improvements, (3) aggressive advertising, and (4) the implementation of programs designed to enhance customer satisfaction.

During 2020, we will continue to apply the same strategic efforts that improved 2019 performance. We are also implementing a new warehouse information system designed to increase productivity and reduce stocking and distribution costs. Management believes that earnings growth will be primarily driven by (1) continued focus on customer satisfaction, (2) penetration into markets currently dominated by national wholesale hardware store chains, and (3) the use of technology to attract additional customers and promote more efficient operations.

## Information Concerning Forward-Looking Statements

This report contains certain forward-looking statements (referenced by such terms as "expects" or "believes") that are subject to the effects of various factors including (1) changes in wholesale hardware prices, (2) changes in the general business environment, (3) the intensity of the competitive arena, (4) new national wholesale hardware chain openings, and (5) certain other matters influencing the Company's ability to react to changing market conditions. Therefore, management wishes to make readers aware that the aforementioned factors could cause the actual results of our operations to differ considerably from those indicated by any forward-looking statements included in this report.

## Hillsburg Hardware Company Five-Year Financial Summary (in thousands)

<b>BALANCE SHEET DATA:</b>	<b>2019</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>
<b>Current assets</b>	\$ 51,027	\$ 49,895	\$ 49,157	\$ 47,689	\$ 46,504
<b>Total assets</b>	61,367	60,791	59,696	57,441	51,580
<b>Current liabilities</b>	13,216	12,350	12,173	12,166	9,628
<b>Long-term notes payable</b>	24,120	26,520	26,938	25,432	25,223
<b>Total stockholders' equity</b>	22,463	20,429	19,135	18,756	15,764
<b>INCOME STATEMENT DATA:</b>					
<b>Net sales</b>	\$ 143,086	\$ 131,226	\$ 122,685	\$ 120,221	\$ 117,115
<b>Cost of sales</b>	103,241	94,876	88,724	88,112	85,663
<b>Gross profit</b>	39,845	36,350	33,961	32,109	31,452
<b>Earnings before income taxes</b>	5,681	4,659	3,351	3,124	1,450
<b>Net income</b>	3,934	3,194	2,279	2,142	994
<b>Cash provided by operating activities</b>	4,910	4,146	2,655	1,811	1,232
<b>Per common share data:</b>					
<b>Net income</b>	\$ 0.79	\$ 0.64	\$ 0.46	\$ 0.43	\$ 0.22
<b>Cash dividends per share</b>	\$ 0.38	\$ 0.38	\$ 0.38	\$ —	\$ —
<b>Common shares outstanding</b>	5,000	5,000	5,000	5,000	4,500
<b>KEY OPERATING RESULTS AND FINANCIAL POSITION RATIOS:</b>					
<b>Gross profit (%)</b>	27.85%	27.70%	27.68%	26.71%	26.86%
<b>Return on assets (%)</b>	9.30%	7.73%	5.72%	5.73%	2.86%
<b>Return on common equity (%)</b>	26.49%	23.55%	17.69%	18.10%	9.50%





PART

1

# THE AUDITING PROFESSION

## Chapters 1–5

**T**hese first five chapters in **PART 1** provide background for performing financial audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

- **Chapters 1 and 2** describe assurance services, including auditing and the role of certified public accounting (CPA) firms and other organizations in performing audits of financial statements and other information.
- **Chapter 3** provides a detailed discussion of audit reports, which are the final products of audits.
- **Chapters 4 and 5** emphasize the regulation and oversight of CPA firms through ethical standards and the legal responsibilities of auditors.

# THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

## CHAPTER

# 1

### Brown Goes Green

United Parcel Service (UPS) is one of the largest shipment and logistics companies in the world, delivering more than 20 million packages a day in more than 220 countries. At the peak of the holiday season, UPS delivers over 30 million packages daily. That's a lot of packages moved by planes and delivery trucks, and it obviously comes with a large carbon footprint. The UPS company nickname is "Brown" because of the company's brown delivery trucks and uniforms, but that does not capture the company's commitment to sustainability.

As a global transportation and logistics company, UPS is aware that greenhouse gas emissions create a serious challenge to the environment and economy. Recently, the company established a goal to reduce absolute greenhouse gas emissions by 12 percent by 2025 throughout its global ground operations. To accomplish this goal, the company intends to have 25 percent of its total electricity come from renewable sources by 2025, and they have committed to an increase in the use of alternative fuels to 40 percent of their total ground fuel use by 2025. These goals build upon the success over the past 10 years where the company saw an overall carbon intensity reduction of 16.6 percent over its baseline at the beginning of the period.



The UPS Corporate Sustainability Report is prepared in accordance with the Global Reporting Initiative (GRI) Sustainability Reporting Standards under the Comprehensive option. The increase in sustainability reporting by companies such as UPS has also resulted in increased interest in the accuracy of the reported information, and the GRI recommends external assurance by accountants or other qualified experts to provide users with increased confidence in the accuracy of the information. The UPS Corporate Sustainability Report includes an assurance report from a Big 4 public accounting firm, including a separate assurance report on the company's global statement of greenhouse gas emissions. Many predict this form of assurance will be a frequent service performed by tomorrow's CPAs.

Sources: 1. UPS Corporate Sustainability Report ([www.sustainability.ups.com](http://www.sustainability.ups.com)); 2. UPS Form 10-K for the year ended December 31, 2017 ([www.ups.com](http://www.ups.com)).

*Each chapter's opening story illustrates important auditing principles based on realistic situations. Some of these stories are based on public information about real companies, whereas others are fictitious. Any resemblance in the latter stories to real firms, companies, or individuals is unintended and purely coincidental.*

### LEARNING OBJECTIVES

*After studying this chapter, you should be able to*

- I-1** Describe auditing.
- I-2** Distinguish between auditing and accounting.
- I-3** Explain the importance of auditing in reducing information risk.
- I-4** List the causes of information risk, and explain how this risk can be reduced.
- I-5** Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.
- I-6** Differentiate the three main types of audits.
- I-7** Identify the primary types of auditors.
- I-8** Describe the requirements for becoming a CPA.

The opening example involving the UPS Corporate Sustainability Report illustrates the increasingly important role of auditors in providing assurance on sustainability and other information of interest to a broad range of stakeholders. Of course, reporting on the financial statements of public companies, as well as private companies, government units, and nonprofit entities, remains a primary role of auditors. In addition, auditors provide assurance on internal control over financial reporting for larger public companies.

This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements, the effectiveness of internal control, and many other types of information. There is also a discussion of the types of audits and auditors, including the requirements for becoming a certified public accountant (CPA).

## NATURE OF AUDITING

### OBJECTIVE 1-1

Describe auditing.

We have introduced the role of auditors in society and how auditors provide assurance on financial statements. Auditors also provide assurance on the effectiveness of internal control over financial reporting, as well as many other types of information such as corporate sustainability reports. We now examine auditing more specifically using the following definition:

**Auditing** is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in a different order than they occur in the description.

### Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. This information can take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Apple's financial statements, the CPA firm will determine whether Apple's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO).

For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Apple's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

### Accumulating and Evaluating Evidence

**Evidence** is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including

- electronic and documentary data about transactions,
- written and electronic communication with outsiders,

- observations by the auditor, and
- oral testimony of the auditee (client).

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and quantity of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit and the primary subject of this book.

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an *independent mental attitude*. The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

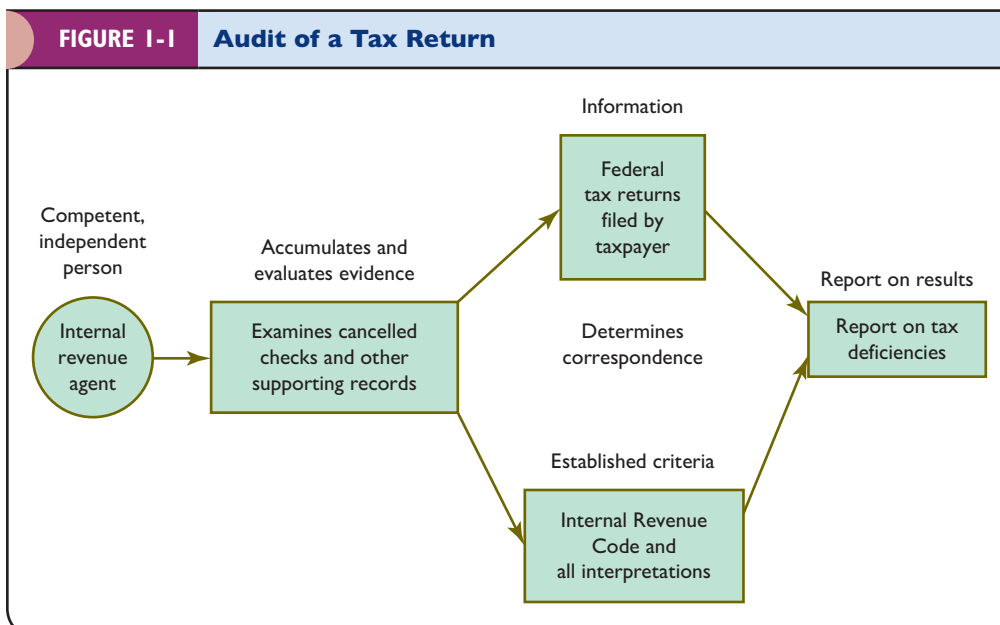
Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called **independent auditors**. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

The final stage in the auditing process is preparing the **audit report**, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

The key parts in the description of auditing are illustrated in Figure 1-1 using an IRS agent's audit of an individual's tax return as an example. To determine whether the tax return was prepared in a manner consistent with the requirements of the federal Internal Revenue Code, the agent examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer. After completing the audit, the internal revenue agent issues a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of the tax return.

**Competent,  
Independent Person**

**Reporting**



## DISTINCTION BETWEEN AUDITING AND ACCOUNTING

### OBJECTIVE 1-2

Distinguish between auditing and accounting.

Many financial statement users and the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title “certified public accountant” to many individuals who perform audits.

**Accounting** is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity’s economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because U.S. or international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must possess expertise in the accumulation and interpretation of audit evidence. That expertise distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

## ECONOMIC DEMAND FOR AUDITING

### OBJECTIVE 1-3

Explain the importance of auditing in reducing information risk.

To illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. This decision will be based on such factors as previous financial relationships with the business and the financial condition of the business as reflected by its financial statements. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in U.S. treasury notes for the same length of time as the business loan.
2. *Business risk for the customer.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions, such as a recession, poor management decisions, or unexpected industry competition.
3. *Information risk.* **Information risk** reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank officer is satisfied that there is minimal information risk because a borrower’s financial statements are audited, the bank’s risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower’s ability to obtain capital at a reasonable cost. For example, assume a large company has total interest-bearing debt of approximately \$10 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is \$100 million.

### Causes of Information Risk

### OBJECTIVE 1-4

List the causes of information risk, and explain how this risk can be reduced.

As society becomes more complex, decision makers are more likely to receive unreliable information due to the remoteness of information, biases and motives of the provider, voluminous data, and the existence of complex exchange transactions.

**Remoteness of Information** In a global economy, it is nearly impossible for a decision maker to have much firsthand knowledge about the organization with which they do business. Information provided by others must be relied upon. When information is



obtained from others, the likelihood of it being intentionally or unintentionally misstated increases.

**Biases and Motives of the Provider** If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favor of the provider. The reason can be honest optimism about future events or an intentional emphasis designed to influence users. In either case, the result is a misstatement of information. For example, when a borrower provides financial statements to a lender, there is considerable likelihood that the borrower will bias the statements to increase the chance of obtaining a loan. The misstatement could be incorrect dollar amounts or inadequate or incomplete disclosures of information.

**Voluminous Data** As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information is included in the records—perhaps buried in a large amount of other information. For example, if a business overpays a vendor's invoice by \$2,000, it is unlikely to be uncovered unless the company has instituted reasonably sophisticated procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total can be significant.

**Complex Exchange Transactions** In the past few decades, exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly. The increasing complexity in transactions has also resulted in increasingly complex accounting standards. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult accounting problems, especially as it relates to fair value estimations. Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly valuing and disclosing derivative financial instruments.

After comparing costs and benefits, business managers and financial statement users may conclude that the best way to deal with information risk is simply to have it remain reasonably high. A small company may find it less expensive to pay higher interest costs than to incur the costs of reducing information risk.

For larger businesses, it is usually practical to incur costs to reduce information risk. There are three main ways to do so.

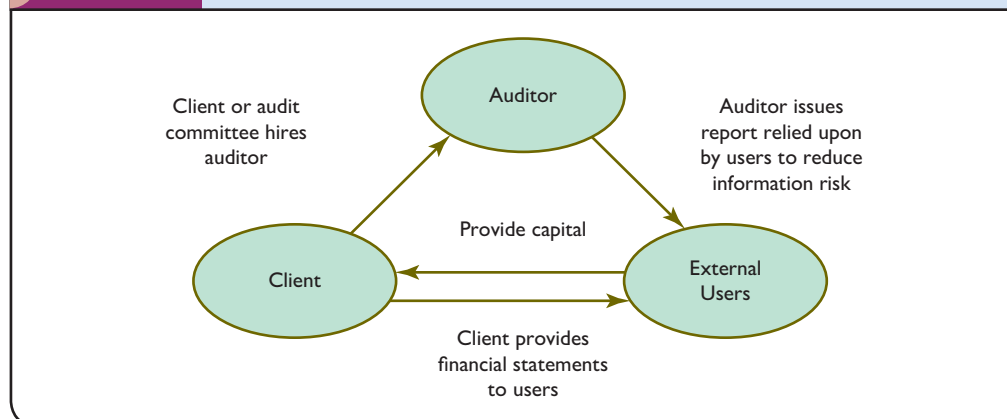
**User Verifies Information** The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of cost. In addition, it is economically inefficient for all users to verify the information individually. Nevertheless, some users perform their own verification. For example, the IRS does considerable verification of business and individual tax returns to determine whether the tax returns filed reflect the actual tax due the federal government. Similarly, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.

**User Shares Information Risk With Management** There is considerable legal precedent indicating that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result incur a financial loss, they may have a basis for a lawsuit against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses. If a company is unable to repay a loan because of bankruptcy, it is unlikely that management will have sufficient funds to repay users.

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## Reducing Information Risk

**FIGURE 1-2 Relationships Among Auditor, Client, and External Users**



**Audited Financial Statements Are Provided** The most common way for users to obtain reliable information is to have an independent audit. Typically, management of a private company or the audit committee for a public company engages the auditor to provide assurances to users that the financial statements are reliable.

External users such as stockholders and lenders who rely on those financial statements to make business decisions look to the auditor's report as an indication of the statements' reliability. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased. They value the auditor's assurance because of the auditor's independence from the client and knowledge of financial statement reporting matters. Figure 1-2 illustrates the relationships among the auditor, client, and financial statement users.

#### CONCEPT CHECK

1. What is meant by determining the degree of correspondence between information and established criteria? What are the criteria for an audit of a company's financial statements?
2. What are the major causes of information risk? How can information risk be reduced?

## ASSURANCE SERVICES

### OBJECTIVE 1-5

Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.

An **assurance service** is an independent professional service that improves the quality of information for decision makers. Such services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions.

Assurance services can be done by CPAs or by a variety of other professionals. For example, Consumers Union, a nonprofit organization, tests a wide variety of products used by consumers and reports their evaluations of the quality of the products tested in *Consumer Reports*. The organization provides the information to help consumers make intelligent decisions about the products they buy. Many consumers consider the information in *Consumer Reports* more reliable than information provided by the product manufacturers because Consumers Union is independent of the manufacturers. Similarly, the Better Business Bureau's (BBB) online reliability program, the BBB Accredited Business Seal, allows Internet shoppers to check BBB information about a company and be assured the company will stand behind its service. Other assurance services provided by firms other than CPAs include the Nielsen television, radio, and Internet ratings.

## CORPORATE RESPONSIBILITY REPORTING EXPANDS GLOBALLY

Companies report corporate responsibility under a number of terms, including corporate responsibility, corporate responsibility reporting, and sustainability reporting. Corporate responsibility reporting continues its tremendous growth, with rapid increases in reporting in emerging economies, and is now standard practice for many companies around the world.

A recent KPMG survey of the top 100 companies based on revenue in 49 countries found that three-fourths of the 4,900 companies issue corporate responsibility reports. All industry sectors show a strong rate of corporate responsibility reporting, with at least 60 percent or more of companies in every industry sector issuing corporate sustainability reports. This is much higher than 10 years earlier when less than 10 percent issued corporate sustainability reports. The percentage of the world's largest 250 companies based on revenues [the Global Fortune 250 (G250)] issuing corporate sustainability reports increased to 78 percent in 2017 as compared to 65 percent in 2015.

The debate has changed from whether corporate responsibility reporting is worth the cost, to what

information should be reported and how it should be presented. As a result, corporate responsibility has become an important element of companies' business strategies to create value for shareholders and other stakeholders.

Reporting using the Global Reporting Initiative (GRI) guidelines is increasingly standard, with 75 percent of reports issued by the G250 companies around the world prepared based on GRI guidelines. Assurance on corporate responsibility reporting is also becoming standard, with 67 percent of the G250 providing external assurance on their responsibility report. Major accounting firms were the choice for providing assurance for two-thirds of the G250 firms that issued responsibility reports with external assurance. These trends suggest providing assurance on corporate responsibility reporting will continue to be an area of significant growth for accounting firms.

Source: KPMG Survey of Corporate Responsibility Reporting 2017, KPMG International.

The need for assurance is not new. CPAs have provided many assurance services for years, particularly assurances about historical financial statement information. As a result of provisions in Section 404 of the **Sarbanes–Oxley Act**, CPA firms provide assurance on internal control over financial reporting for larger public companies. More recently, CPAs have expanded the types of assurance services they perform to include other information of interest to investors, customers, and other interested parties, such as reports on corporate social responsibility and sustainability reports. For example, businesses and consumers often seek assurances that companies with which they conduct business produce products and services in a socially responsible manner. The demand for assurance services continues to grow as shareholders and other stakeholders seek assurances about financial and nonfinancial information in addition to information in corporate financial reports.

One category of assurance services provided by CPAs is attestation services. An **attestation service** is a type of assurance service in which the CPA firm issues a report about a subject matter or assertion that is made by another party. Primary categories of attestation services include

- audit of historical financial statements,
- audit of internal control over financial reporting,
- review of historical financial statements, and
- other attestation services that may be applied to a broad range of subject matter.

**Audit of Historical Financial Statements** In an **audit of historical financial statements**, management asserts that the financial statements are fairly stated in accordance with applicable U.S. or international accounting standards. An audit of these statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the applicable accounting standards. These audits are the most common assurance service provided by CPA firms.

Audits are designed to provide reasonable assurance that the financial statements are free of material misstatements. Reasonable assurance is a high, but not absolute

### Attestation Services

level of assurance. This level of assurance is usually sufficient to meet the information needs of financial statement users. Much of this book is about how auditors design tests to provide this level of assurance, considering the client's business and industry and risks of material misstatements in the financial statements.

Publicly traded companies in the United States are required to have audits under the federal securities acts. Auditor reports can be found in all public companies' annual financial reports. Most public companies' audited financial statements can be accessed over the Internet from the Securities and Exchange Commission (SEC) EDGAR database or directly from each company's website. Many privately held companies also have their annual financial statements audited to obtain financing from banks and other financial institutions. Government and not-for-profit entities often have audits to meet the requirements of lenders or funding sources.

**Audit of Internal Control Over Financial Reporting** For an audit of **internal control over financial reporting**, management asserts that internal controls have been developed and implemented following well established criteria. Section 404 of the Sarbanes–Oxley Act requires public companies to report management's assessment of the effectiveness of internal control. The Act also requires auditors for larger public companies to attest to the effectiveness of internal control over financial reporting. This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting because effective internal controls reduce the likelihood of future misstatements in the financial statements.

**Review of Historical Financial Statements** For a **review of historical financial statements**, management asserts that the statements are fairly stated in accordance with accounting standards, the same as for audits. The CPA provides a lower level of assurance for reviews of financial statements compared to a high level for audits; therefore, less evidence is needed. A review is often adequate to meet financial statement users' needs. It can be provided by the CPA firm at a much lower fee than an audit because less evidence is needed. Many nonpublic companies use this attestation option to provide limited assurance on their financial statements without incurring the cost of an audit.

**Other Attestation Services** CPAs provide numerous other attestation services. Typically, the CPA is engaged to provide written assurance about the reliability of an assertion made by management. Many of these services are natural extensions of the audit of historical financial statements, as users seek independent assurances about other types of information. For example, when a bank loans money to a company, the loan agreement may require the company to engage a CPA to provide assurance about the company's compliance with the financial provisions of the loan. The company requesting the loan must assert the loan provisions to be attested to before the CPA can accumulate the evidence needed to issue the attestation report.

Another type of attestation involves internal controls at service organizations. Many companies use a third-party service provider to process some of their accounting activities, such as payroll, offsite at a separate IT service center or through cloud computing. The service provider often engages an auditor to provide an attestation report on the design and effectiveness of controls at the service organization. This report provides assurance to companies that use the service provider that payroll is accurately processed. Auditors of companies using the payroll service organization can also rely on the attestation report by the service company's auditor to reduce testing of payroll activities and accounts.

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## Other Assurance Services

CPAs also provide other assurance services that do not meet the definition of attestation services. These assurance services differ from attestation services in that the CPA is not required to issue a written report, and the assurance does not have to be about the reliability of another party's assertion about compliance with specified criteria. These other assurance service engagements focus on improving the quality of information for decision makers, just like attestation services.

“AND THE  
OSCAR GOES  
TO...” “THERE  
SHE IS, MISS  
AMERICA...”  
“WELCOME TO  
THE NEW YORK  
STATE LOTTERY...”

You probably recognize these statements from the Academy Awards, the Miss America Pageant, and the New York State Lottery drawing. Each event is observed by CPAs from a major accounting firm to assure viewers that the contests were fairly conducted. The role of the accounting profession in providing assurance about the award selection process and winners made headline news in 2017 when a distracted partner with PricewaterhouseCoopers (PwC) accidentally gave the wrong envelope to the Best Picture presenters, resulting in the wrong

picture, *La La Land*, being announced as the top film instead of *Moonlight*, the actual winner. Fortunately, the Academy of Motion Picture Arts and Sciences recognized PwC's work over the past 85 years for the Academy and voted to keep PwC as its accounting firm of record, although the partner involved for the blunder will no longer be involved. PwC redeemed itself with the 2018 awards show, which went without a hitch. When you become a member of a CPA firm, you might not win an Oscar—but you could be on the Oscars!

CPA firms face a larger field of competitors in the market for other assurance services. Audits and some types of attestation services are limited by regulation to licensed CPAs, but the market for other forms of attestation and assurance is open to non-CPA competitors. For example, CPAs must compete with market research firms to assist clients in the preparation of customer surveys and in the evaluation of the reliability and relevance of survey information. However, CPA firms have the competitive advantage of their reputation for competence and independence.

The types of assurance services that CPAs can provide are almost limitless. A survey of large CPA firms identified more than 200 assurance services that are currently being provided. Table 1-1 lists some of the other assurance service opportunities for CPAs. Additional information on the performance of assurance and attestation services is included in Chapter 25.

CPA firms perform numerous other services that generally fall outside the scope of assurance services. Three specific examples:

1. Accounting and bookkeeping services
2. Tax services
3. Management consulting services

Most accounting and bookkeeping services, tax services, and management consulting services fall outside the scope of assurance services, although there is similarity between some consulting and assurance services. While the primary purpose

### Nonassurance Services Provided by CPAs

**TABLE 1-1 Other Assurance Services Examples**

Other Assurance Services	Service Activities
Controls over and risks related to investments, including policies related to derivatives	Assess the processes in a company's investment practices to identify risks and to determine the effectiveness of those processes
Mystery shopping	Perform anonymous shopping to assess sales personnel dealings with customers and procedures they follow
Assess risks of accumulation, distribution, and storage of digital information	Assess security risks and related controls over electronic data, including the adequacy of backup and off-site storage
Fraud and illegal acts risk assessment	Develop fraud risk profiles and assess the adequacy of company systems and policies in preventing and detecting fraud and illegal acts
Organic ingredients	Provide assurance on the amount of organic ingredients included in a company's products
Compliance with entertainment royalty agreements	Assess whether royalties paid to artists, authors, and others comply with royalty agreements
ISO 9000 certifications	Certify a company's compliance with ISO 9000 quality control standards, which help ensure company products are of high quality
Corporate responsibility and sustainability	Report on whether the information in a company's corporate responsibility report is consistent with company information and established reporting criteria