PART 2

THE PROCESS OF AUDITING

CHAPTERS 6 – 13

Part 2 presents the audit process in a manner that will enable you to apply the concepts developed in these chapters to any audit area. Because the planning concepts covered in these chapters will be used extensively throughout the rest of the book, it is essential for you to master this material and fully understand the importance of audit planning.

- **Chapters 6 and 7** deal with auditors' and managements' responsibilities, audit objectives, and general audit evidence concepts.
- **Chapters 8 through 12** study various aspects of audit planning in depth, including risk assessment and auditors' responsibility for detecting fraud.
- **Chapter 13** summarizes and integrates audit planning and audit evidence.

Throughout the remainder of the book, many of the concepts are illustrated with examples based on the Hillsburg Hardware Company. The financial statements and other information from the company's annual report are included in the glossy insert material to the textbook.

CHAPTER 6

AUDIT RESPONSIBILITIES AND OBJECTIVES

Riding the Tiger: Indian Computer Company Engages in Billion Dollar Fraud

During the period 2003 to 2008, Satyam Computer Services Limited, an information technology services company based in Hyderabad, India, that serviced more than a third of the Fortune 500 companies, roiled Indian stock markets when it announced it deceived investors by engaging in a massive fraud. Company chairman Ramalinga Raju resigned after announcing that 50.4 billion rupees ($1.04 billion) of the 53.6 billion rupees the company listed as assets in its financial statements for the second quarter ending in September 2008 did not exist.

During the period of the fraud, senior management manufactured over 6,000 fictitious invoices representing over $1 billion in revenue for services that were never provided, in some cases for customers that did not exist. Management also created false bank statements to reflect payments on the false invoices and support the fictitious cash balances. Satyam provided certain employees with an administrative "super user" login identification and password that allowed them to access the invoice management system to record the false invoices. This process allowed those invoices to be included in revenue, but concealed their existence from the heads of Satyam's business units, who would recognize that the services had not been provided.

Satyam's auditors sent confirmations to verify the existence of the bank balances. However, they did not maintain control over the confirmations as required by auditing standards. The audit engagement team relied on Satyam management to mail out the confirmation requests to the banks, and to return the confirmation responses to the engagement team, instead of directly contacting the banks as required by auditing standards.

Raju admitted that he intentionally maintained the inflated revenues and profits because public knowledge of the company's poor performance would likely lead to a takeover of the company, thereby exposing the fraud. Raju indicated, "It was like riding a tiger, not knowing how to get off without being eaten." On January 7, 2009, the New York Stock Exchange suspended trading of the company's American Depository Shares (ADS). When trading resumed on January 12, 2009, Satyam's ADS price declined nearly 85 percent to close at $1.46. The Government of India assumed control of the company by dissolving Satyam's Board of Directors and then selected a strategic investor to run the company.

Sources: 1. "SEC Charges Satyam Computer Services with Financial Fraud," April 5, 2011 (www.sec.gov/news/press/2011/2011-81.htm); 2. SEC Litigation Release 21915, April 5, 2011 (www.sec.gov/litigation/complaints/2011/comp21915.pdf); 3. PCAOB Release No. 105-2011-002, April 5, 2011 (pcaobus.org/Enforcement/Decisions/Documents/PW_India.pdf).

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **6-1** Explain the objective of conducting an audit of financial statements and an audit of internal controls.
- **6-2** Distinguish management's responsibility for the financial statements and internal control from the auditor's responsibility for verifying the financial statements and effectiveness of internal control.
- **6-3** Explain the auditor's responsibility for discovering material misstatements due to fraud or error, and the need to maintain professional skepticism when conducting the audit.
- **6-4** Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.
- **6-5** Describe why the auditor obtains a combination of assurance by auditing classes of transactions and ending balances in accounts, including presentation and disclosure.
- **6-6** Distinguish among the three categories of management assertions about financial information.
- **6-7** Link the six general transaction-related audit objectives to management assertions for classes of transactions.
- **6-8** Link the eight general balance-related audit objectives to management assertions for account balances.
- **6-9** Link the four presentation and disclosure-related audit objectives to management assertions for presentation and disclosure.
- **6-10** Explain the relationship between audit objectives and the accumulation of audit evidence.

The Satyam story illustrates failure by the auditors to achieve the objectives of the audit of the company's financial statements. This chapter describes the overall objectives of the audit, the auditor's responsibilities in conducting the audit, and the specific objectives the auditor tries to accomplish. Without an understanding of these topics, planning and accumulating audit evidence during the audit has no relevance. Figure 6-1 summarizes the five topics that provide keys to understanding evidence accumulation. These are the steps used to develop specific audit objectives.

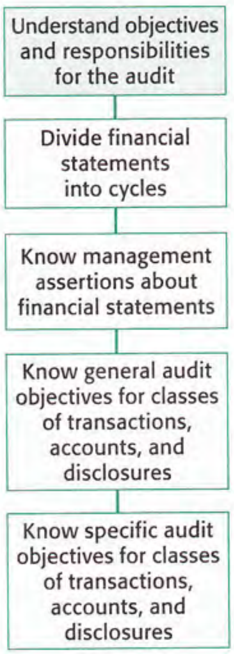
OBJECTIVE OF CONDUCTING AN AUDIT OF FINANCIAL STATEMENTS

OBJECTIVE 6-1

Explain the objective of conducting an audit of financial statements and an audit of internal controls.

The preface to the clarified AICPA auditing standards indicates

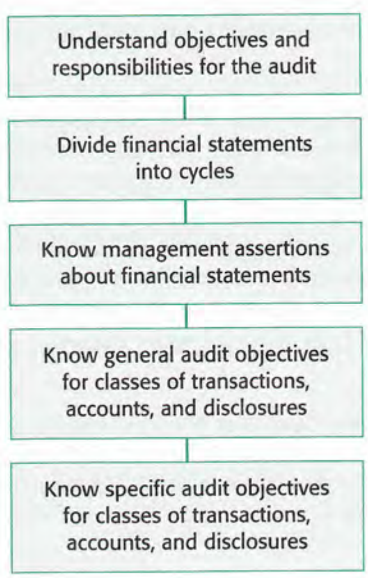
> The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial accounting framework. An auditor's opinion enhances the degree of confidence that intended users can place in the financial statements.



Our primary focus is the section that emphasizes issuing an opinion on *financial statements*. For larger public companies, the auditor also issues a report on internal control over financial reporting as required by Section 404 of the Sarbanes–Oxley Act. Auditors accumulate evidence in order to reach conclusions about whether the financial statements are fairly stated and to determine the effectiveness of internal control, after which they issue the appropriate audit report.

If the auditor believes that the statements are not fairly presented or is unable to reach a conclusion because of insufficient evidence, the auditor has the responsibility of notifying users through the auditor's report. Subsequent to their issuance, if facts indicate that the statements were not fairly presented, as in the Satyam case, the auditor will probably have to demonstrate to the courts or regulatory agencies that the audit was conducted in a proper manner and the auditor reached reasonable conclusions.

FIGURE 6-1 **Steps to Develop Audit Objectives**



MANAGEMENT'S RESPONSIBILITIES

OBJECTIVE 6-2

Distinguish management's responsibility for the financial statements and internal control from the auditor's responsibility for verifying the financial statements and effectiveness of internal control.

The responsibility for adopting sound accounting policies, maintaining adequate internal control, and making fair representations in the financial statements *rests with management* rather than with the auditor. Because they operate the business daily, a company's management knows more about the company's transactions and related assets, liabilities, and equity than the auditor. In contrast, the auditor's knowledge of these matters and internal control is limited to that acquired during the audit.

The annual reports of many public companies include a statement about management's responsibilities and relationship with the CPA firm. Figure 6-2 presents selected sections of the report of management for International Business Machines (IBM) Corporation as a part of its annual report. Read the report carefully to determine what management states about its responsibilities.

Management's responsibility for the integrity and fairness of the representations (assertions) in the financial statements carries with it the privilege of determining which presentations and disclosures it considers necessary. If management insists on financial statement disclosure that the auditor finds unacceptable, the auditor can either issue an adverse or qualified opinion or withdraw from the engagement.

The Sarbanes–Oxley Act requires the chief executive officer (CEO) and the chief financial officer (CFO) of public companies to certify the quarterly and annual financial statements submitted to the SEC. In signing those statements, management certifies that the financial statements fully comply with the requirements of the Securities Exchange Act of 1934 and that the information contained in the financial statements fairly present, in all material respects, the financial condition and results of operations. The Sarbanes–Oxley Act provides for criminal penalties, including

FIGURE 6-2 **International Business Machines Corporation's Report of Management**

REPORT OF MANAGEMENT

International Business Machines Corporation and Subsidiary Companies

Management Responsibility for Financial Information

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. An important element of the control environment is an ongoing internal audit program. Our system also contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

[third and fourth paragraphs omitted]

The Audit Committee of the Board of Directors is composed solely of independent, non-management directors, and is responsible for recommending to the Board the independent registered public accounting firm to be retained for the coming year, subject to stockholder ratification. The Audit Committee meets periodically and privately with the independent registered public accounting firm, with the company's internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure, and financial reporting matters.

Virginia M. Rometty
President and Chief Executive Officer
February 28, 2012

Mark Loughridge
Senior Vice President and Chief Financial Officer,
Finance and Enterprise Transformation
February 28, 2012

significant monetary fines or imprisonment up to 20 years, for anyone who knowingly falsely certifies those statements.

AUDITOR'S RESPONSIBILITIES

OBJECTIVE 6-3

Explain the auditor's responsibility for discovering material misstatements due to fraud or error, and the need to maintain professional skepticism when conducting the audit.

AICPA auditing standards state

> The overall objectives of the auditor, in conducting an audit of financial statements, are to:
> (a) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
> (b) report on the financial statements, and communicate as required by auditing standards, in accordance with the auditor's findings.

Source: Statements on Auditing Standards, 122–124, Issued by the Auditing Standards Board (October 2011).

This paragraph discusses the auditor's responsibility for detecting material misstatements in the financial statements. When the auditor also reports on the effectiveness of internal control over financial reporting, the auditor is also responsible for identifying material weaknesses in internal control over financial reporting. The auditor's responsibilities for audits of internal control are discussed in Chapter 10.

This paragraph and the related discussion in the standards about the auditor's responsibility to detect material misstatements include several important terms and phrases.

Material Versus Immaterial Misstatements Misstatements are usually considered material if the combined uncorrected errors and fraud in the financial statements would likely have changed or influenced the decisions of a reasonable person using the statements. Although it is difficult to quantify a measure of materiality, auditors are responsible for obtaining reasonable assurance that this materiality threshold has been satisfied. It would be extremely costly (and probably impossible) for auditors to have responsibility for finding all immaterial errors and fraud.

Reasonable Assurance Assurance is a measure of the level of certainty that the auditor has obtained at the completion of the audit. Auditing standards indicate reasonable assurance is a high, but not absolute, level of assurance that the financial statements are free of material misstatements. The concept of reasonable, but not absolute, assurance indicates that the auditor is not an insurer or guarantor of the correctness of the financial statements. Thus, an audit that is conducted in accordance with auditing standards may fail to detect a material misstatement.

The auditor is responsible for reasonable, but not absolute, assurance for several reasons:

1. Most audit evidence results from testing a sample of a population such as accounts receivable or inventory. Sampling inevitably includes some risk of not uncovering a material misstatement. Also, the areas to be tested; the type, extent, and timing of those tests; and the evaluation of test results require significant auditor judgment. Even with good faith and integrity, auditors can make mistakes and errors in judgment.
2. Accounting presentations contain complex estimates, which inherently involve uncertainty and can be affected by future events. As a result, the auditor has to rely on evidence that is persuasive, but not convincing.
3. Fraudulently prepared financial statements are often extremely difficult, if not impossible, for the auditor to detect, especially when there is collusion among management.

If auditors were responsible for making certain that all the assertions in the statements were correct, the types and amounts of evidence required and the resulting cost of the audit function would increase to such an extent that audits would not be economically practical. Even then, auditors would be unlikely to uncover all material misstatements in every audit. The auditor's best defense when material misstatements are not uncovered is to have conducted the audit in accordance with auditing standards.

Errors Versus Fraud Auditing standards distinguish between two types of misstatements: errors and fraud. Either type of misstatement can be material or immaterial. An **error** is an *unintentional* misstatement of the financial statements, whereas **fraud** is *intentional*. Two examples of errors are: a mistake in extending price times quantity on a sales invoice and overlooking older raw materials in determining the lower of cost or market for inventory.

For fraud, there is a distinction between **misappropriation of assets**, often called defalcation or employee fraud, and **fraudulent financial reporting**, often called management fraud. An example of misappropriation of assets is a clerk taking cash at the time a sale is made and not entering the sale in the cash register. An example of fraudulent financial reporting is the intentional overstatement of sales near the balance sheet date to increase reported earnings.

Professional Skepticism Auditing standards require that an audit be designed to provide reasonable assurance of detecting *both* material errors and fraud in the financial statements. To accomplish this, the audit must be planned and performed with an *attitude of professional skepticism* in all aspects of the engagement.

Aspects of Professional Skepticism Professional skepticism consists of two primary components: a questioning mind and a critical assessment of the audit evidence. While auditors would like to believe that the organizations they accept as clients have integrity and are honest, maintaining a questioning mind helps auditors offset the natural bias to want to trust the client. A questioning mindset means the auditor approaches the audit with a "trust but verify" mental outlook. Similarly, as they obtain and evaluate evidence supporting financial statement amounts and disclosures, professional skepticism also involves a critical assessment of the evidence that includes asking probing questions and attention to inconsistencies. When auditors embrace the responsibility to maintain a questioning mind and to critically evaluate evidence, they significantly reduce the likelihood of audit failure throughout the audit.

Elements of Professional Skepticism While the concept of professional skepticism has been a foundational element of auditing standards for years, it continues to be difficult to implement in practice. Unfortunately, auditors are human and thus are subject to natural biases to trust individuals they know and with whom they interact on a regular basis. In an audit environment, auditors sometimes convince themselves that they only accept clients they can trust and that have high integrity. Thus, it is often difficult for auditors to embrace the possibility that even their clients may lack competence or may try to deceive them throughout the entire audit process. Despite these limitations, auditors need to work to overcome these judgment biases and they need to be continually reminded of the importance of maintaining appropriate professional skepticism, and recognize that the risk of material misstatements is present in all audits.

Recent academic research on the topic of professional skepticism suggests there are six characteristics of skepticism:[1]

1. Questioning mindset—a disposition to inquiry with some sense of doubt
2. Suspension of judgment—withholding judgment until appropriate evidence is obtained

[1]Based on "Development of a Scale to Measure Professional Skepticism," by R. Kathy Hurtt, *Auditing: A Journal of Practice & Theory*, May 2010.

CABLE MOGULS ARRESTED FOR CORPORATE LOOTING

Sometimes, misappropriation of assets involves significant amounts and occurs at the very top of the organization. In 2002 the SEC charged former Adelphia CEO John Rigas and other Rigas family members with "rampant self dealing" at Adelphia Communications Corp. in what has been called one of the most extensive financial frauds ever to take place at a public company. According to the SEC complaint, the Rigas family used Adelphia funds to finance open market purchases of stock, pay off margin loans and other family debts, purchase timber rights, construct a golf club, and purchase luxury condominiums in Colorado, Mexico, and New York City.

In the criminal complaint, prosecutors charged that the Rigas family "looted Adelphia on a massive scale, using the company as the Rigas family's personal piggy bank, at the expense of public investors and creditors." After details of the misappropriations and fraudulent reporting in the company's financial statements became public, Adelphia filed for bankruptcy, and its stock collapsed from a price of $20 per share to less than $1 per share. John Rigas was convicted and sentenced to 15 years in prison; his son Timothy, the company's former CFO, was sentenced to 20 years in prison.

Sources: 1. "Adelphia founder sentenced to 15 years" (money.cnn.com/2005/06/20/news/newsmakers/rigas_sentencing/); 2. SEC press release 2002-110 (www.sec.gov/news/press/2002-110.htm).

3. Search for knowledge—a desire to investigate beyond the obvious, with a desire to corroborate
4. Interpersonal understanding—recognition that people's motivations and perceptions can lead them to provide biased or misleading information
5. Autonomy—the self-direction, moral independence, and conviction to decide for oneself, rather than accepting the claims of others
6. Self-esteem—the self-confidence to resist persuasion and to challenge assumptions or conclusions

Awareness of these six elements throughout the engagement can help auditors fulfill their responsibility to maintain an appropriate level of professional skepticism. Asking the right questions and probing further with follow-up questions until the auditor is satisfied with the responses, while being alert to unusual behaviors from respondents as they answer questions, can make the difference between detecting and failing to detect a material misstatement in the financial statements.

Auditor's Responsibilities for Detecting Material Errors

Auditors spend a great portion of their time planning and performing audits to detect unintentional mistakes made by management and employees. Auditors find a variety of errors resulting from such things as mistakes in calculations, omissions, misunderstanding and misapplication of accounting standards, and incorrect summarizations and descriptions. Throughout the rest of this book, we consider how the auditor plans and performs audits for detecting both errors and fraud.

Auditor's Responsibilities for Detecting Material Fraud

Auditing standards make no distinction between the auditor's responsibilities for searching for errors and fraud. In either case, the auditor must obtain reasonable assurance about whether the statements are free of material misstatements. The standards also recognize that fraud is often more difficult to detect because management or the employees perpetrating the fraud *attempt to conceal the fraud*, similar to the Satyam case. Still, the difficulty of detection does not change the auditor's responsibility to properly plan and perform the audit to detect material misstatements, whether caused by error or fraud.

Fraud Resulting from Fraudulent Financial Reporting Versus Misappropriation of Assets Both fraudulent financial reporting and misappropriation of assets are potentially harmful to financial statement users, but there is an important difference between them. Fraudulent financial reporting harms users by providing them incorrect financial statement information for their decision making. When assets are misappropriated, stockholders, creditors, and others are harmed because assets are no longer available to their rightful owners.

Typically, fraudulent financial reporting is committed by management, sometimes without the knowledge of employees. Management is in a position to make accounting and reporting decisions without employees' knowledge. An example is the decision to omit an important footnote disclosure about pending litigation.

Usually, but not always, theft of assets is perpetrated by employees and not by management, and the amounts are often immaterial. However, there are well-known examples of extremely material misappropriation of assets by employees and management, similar to the Adelphia fraud described in the vignette box at the top of the previous page.

There is an important distinction between the theft of assets and misstatements arising from the theft of assets. Consider the following three situations:

1. Assets were taken and the theft was covered by misstating assets. For example, cash collected from a customer was stolen before it was recorded as a cash receipt, and the account receivable for the customer's account was not credited. The misstatement has not been discovered.
2. Assets were taken and the theft was covered by understating revenues or overstating expenses. For example, cash from a cash sale was stolen, and the transaction was not recorded. Or, an unauthorized disbursement to an employee was recorded as a miscellaneous expense. The misstatement has not been discovered.
3. Assets were taken, but the misappropriation was discovered. The income statement and related footnotes clearly describe the misappropriation.

In all three situations, there has been a misappropriation of assets, but the financial statements are misstated only in situations 1 and 2. In situation 1, the balance sheet is misstated, whereas in situation 2, revenues or expenses are misstated.

Auditor's Responsibility to Consider Laws and Regulations

In obtaining reasonable assurance that the financial statements are free of material misstatement, the auditor takes into account applicable legal and regulatory frameworks relevant to the client. For example, when auditing the financial statements of a bank, the auditor would need to consider requirements of banking regulators such as the FDIC, Federal Reserve, or state banking commission, among others. The auditor's ability to detect material misstatements arising from failure to comply with laws and regulations is impacted by the following factors:

- Many laws and regulations primarily relate to operating aspects of the business and typically do not affect the financial statements and are not captured by the client's information systems related to financial reporting.
- Noncompliance may involve actions to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations made to the auditor.
- Whether an act constitutes noncompliance is a matter for legal determination, such as by a court of law.

One of the difficulties for the auditor is determining how laws and regulations impact financial statement amounts and disclosures. As the impact from noncompliance is further removed from affecting financial statements, the less likely the auditor is to become aware of or recognize noncompliance when auditing the financial statements. The auditor's responsibilities regarding **noncompliance with laws and regulations** (frequently referred to as illegal acts) depend on whether the laws or regulations are expected to have a direct effect on the amounts and disclosures in the financial statements.

Laws and Regulations with a Direct Effect on the Financial Statements

The provisions of certain laws and regulations, such as tax and pension laws and regulations, are generally recognized to have a direct effect on the amounts and disclosures in the financial statements. For example, a violation of federal tax laws directly affects income tax expense and income taxes payable. The auditor should obtain sufficient appropriate evidence regarding material amounts and disclosures that are directly affected by laws and regulations. For example, in auditing income tax expense, to identify whether there have been any material violations of federal or state tax laws, the auditor might hold discussions with client personnel and examine reports issued by the Internal Revenue Service after completion of an examination of the client's tax return.

Laws and Regulations That Do Not Have a Direct Effect on the Financial Statements The provisions of many laws and regulations are unlikely to have a direct effect on the financial statements. However, compliance with those laws and regulations is often fundamental to operation of the business and necessary to avoid material penalties. Examples include complying with the terms of an operating license, federal employee safety requirements, and environmental regulations.

The auditor should perform the following procedures to identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements:

- Inquire of management and those charged with governance about whether the entity is in compliance with such laws and regulations.
- Inspect correspondence, if any, with the relevant licensing or regulatory authorities.

During the audit, other audit procedures may bring instances of suspected noncompliance to the auditor's attention. However, in the absence of identified or suspected noncompliance, the auditor is not required to perform audit procedures beyond those previously discussed.

Audit Procedures When Noncompliance is Identified or Suspected If the auditor becomes aware of information concerning an instance of noncompliance or suspected noncompliance with laws and regulations, the auditor should obtain an understanding of the nature and circumstances of the act. Additional information should be obtained to evaluate the possible effects on the financial statements.

The auditor should discuss the matter with management at a level above those involved with the suspected noncompliance and, when appropriate, those charged with governance. If management or those charged with governance are unable to provide sufficient information that supports that the entity is in compliance with the laws and regulations, and the auditor believes the effect of the noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice. The auditor should also evaluate the effects of the noncompliance on other aspects of the audit, including the auditor's risk assessment and the reliability of other representations from management.

Reporting of Identified or Suspected Noncompliance Unless the matters involved are inconsequential, the auditor should communicate with those charged with governance matters involving noncompliance with laws and regulations that came to the auditor's attention during the course of the audit. If the matter involved is believed to be intentional and material, it should be communicated to those charged with governance, such as the board of directors, as soon as practicable. The auditor should also identify whether a responsibility exists to report the identified or suspected noncompliance to parties outside the entity, such as regulatory authorities.

If the noncompliance has a material effect and has not been adequately reflected in the financial statements, the auditor should express a qualified or adverse opinion on the financial statements. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate evidence to evaluate whether noncompliance that may be material to the financial statements has occurred or is likely to have occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of the scope limitation.

FINANCIAL STATEMENT CYCLES

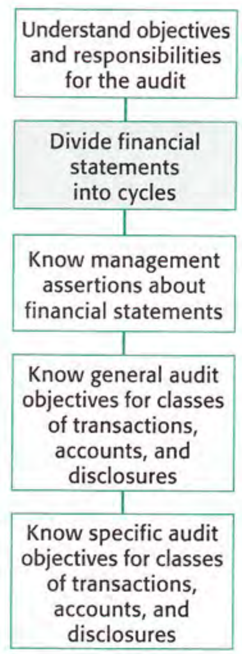
OBJECTIVE 6-4

Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.

Audits are performed by dividing the financial statements into smaller segments or components. The division makes the audit more manageable and aids in the assignment of tasks to different members of the audit team. For example, most auditors treat fixed assets and notes payable as different segments. Each segment is audited separately but not on a completely independent basis. (For example, the audit of fixed assets may reveal an unrecorded note payable.) After the audit of each segment is completed, including interrelationships with other segments, the results are combined. A conclusion can then be reached about the financial statements taken as a whole.

There are different ways of segmenting an audit. One approach is to treat every account balance on the statements as a separate segment. Segmenting that way is usually inefficient. It would result in the independent audit of such closely related accounts as inventory and cost of goods sold.

Cycle Approach to Segmenting an Audit



A common way to divide an audit is to keep closely related types (or classes) of transactions and account balances in the same segment. This is called the **cycle approach.** For example, sales, sales returns, cash receipts, and charge-offs of uncollectible accounts are the four classes of transactions that cause accounts receivable to increase and decrease. Therefore, they are all parts of the sales and collection cycle. Similarly, payroll transactions and accrued payroll are parts of the payroll and personnel cycle.

The logic of using the cycle approach is that it ties to the way transactions are recorded in journals and summarized in the general ledger and financial statements. Figure 6-3 shows that flow. To the extent that it is practical, the cycle approach combines transactions recorded in different journals with the general ledger balances that result from those transactions.

The cycles used in this text are listed below and are then explained in detail. Note that each of these cycles is so important that one or more later chapters address the audit of each cycle:

- Sales and collection cycle
- Acquisition and payment cycle
- Payroll and personnel cycle
- Inventory and warehousing cycle
- Capital acquisition and repayment cycle

FIGURE 6-3 Transaction Flow from Journals to Financial Statements

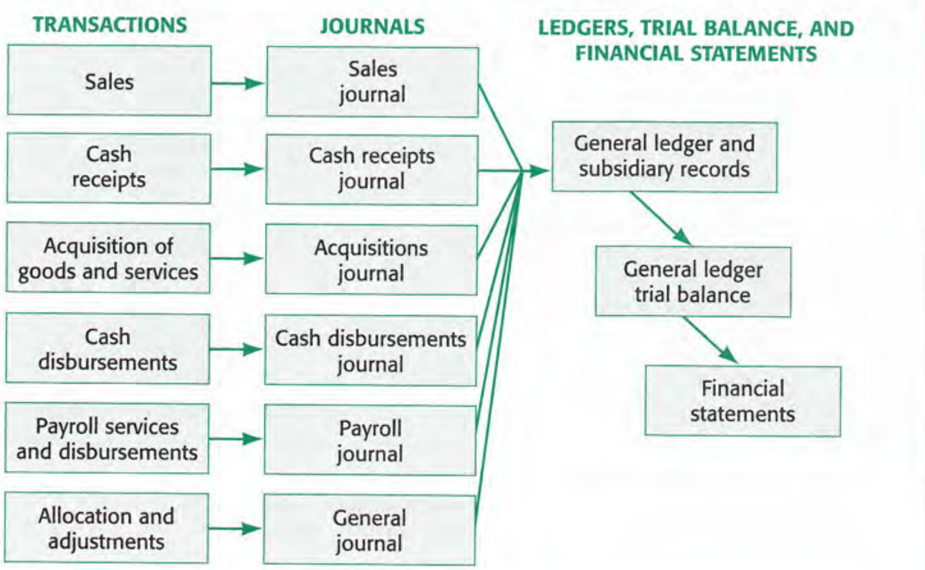


FIGURE 6-4 **Hillsburg Hardware Co. Adjusted Trial Balance**

HILLSBURG HARDWARE CO.
TRIAL BALANCE
December 31, 2013

		Debit	Credit
S,A,P,C	Cash in bank	$ 827,568	
S	Trade accounts receivable	20,196,800	
S	Allowance for uncollectible accounts		$ 1,240,000
S	Other accounts receivable	945,020	
A,I	Inventories	29,864,621	
A	Prepaid expenses	431,558	
A	Land	3,456,420	
A	Buildings	32,500,000	
A	Computer and other equipment	3,758,347	
A	Furniture and fixtures	2,546,421	
A	Accumulated depreciation		31,920,126
A	Trade accounts payable		4,719,989
C	Notes payable		4,179,620
P	Accrued payroll		1,349,800
P	Accrued payroll taxes		119,663
C	Accrued interest		149,560
C	Dividends payable		1,900,000
A	Accrued income tax		795,442
C	Long-term notes payable		24,120,000
A	Deferred tax		738,240
A	Other accrued payables		829,989
C	Capital stock		5,000,000
C	Capital in excess of par value		3,500,000
C	Retained earnings		11,929,075
S	Sales		144,327,789
S	Sales returns and allowances	1,241,663	
I	Cost of goods sold	103,240,768	
P	Salaries and commissions	7,738,900	
P	Sales payroll taxes	1,422,100	
A	Travel and entertainment—selling	1,110,347	
A	Advertising	2,611,263	
A	Sales and promotional expense	321,620	
A	Sales meetings and training	924,480	
A	Miscellaneous sales expense	681,041	
P	Executive and office salaries	5,523,960	
P	Administrative payroll taxes	682,315	
A	Travel and entertainment—administrative	561,680	
A	Computer maintenance and supplies	860,260	
A	Stationery and supplies	762,568	
A	Postage	244,420	
A	Telecommunications	722,315	
A	Rent	312,140	
A	Legal fees and retainers	383,060	
A	Auditing and related services	302,840	
A	Depreciation	1,452,080	
S	Bad debt expense	3,323,084	
A	Insurance	722,684	
A	Office repairs and maintenance	843,926	
A	Miscellaneous office expense	643,680	
A	Miscellaneous general expense	323,842	
A	Gain on sale of assets		719,740
A	Income taxes	1,746,600	
C	Interest expense	2,408,642	
C	Dividends	1,900,000	
		$237,539,033	$237,539,033

Note: Letters in the left-hand column refer to the following transaction cycles:

S = Sales and collection
A = Acquisition and payment
P = Payroll and personnel
I = Inventory and warehousing
C = Capital acquisition and repayment

TABLE 6-1 **Cycles Applied to Hillsburg Hardware Co.**

Cycle	Journals Included in the Cycle (See Figure 6-3, p. 169)	General Ledger Accounts Included in the Cycle (See Figure 6-4) Balance Sheet	Income Statement
Sales and collection	Sales journal Cash receipts journal General journal	Cash in bank Trade accounts receivable Other accounts receivable Allowance for uncollectible accounts	Sales Sales returns and allowances Bad debt expense
Acquisition and payment	Acquisitions journal Cash disbursements journal General journal	Cash in bank Inventories Prepaid expenses Land Buildings Computer and other equipment Furniture and fixtures Accumulated depreciation Trade accounts payable Other accrued payables Accrued income tax Deferred tax	Advertising[S] Travel and entertainment[S] Sales meetings and training[S] Sales and promotional expense[S] Miscellaneous sales expense[S] Travel and entertainment[A] Stationery and supplies[A] Postage[A] Telecommunications[A] Computer maintenance and supplies[A] Depreciation[A] Rent[A] Legal fees and retainers[A] Auditing and related services[A] Insurance[A] Office repairs and maintenance expense[A] Miscellaneous office expense[A] Miscellaneous general expense[A] Gain on sale of assets Income taxes
Payroll and personnel	Payroll journal General journal	Cash in bank Accrued payroll Accrued payroll taxes	Salaries and commissions[S] Sales payroll taxes[S] Executive and office salaries[A] Administrative payroll taxes[A]
Inventory and warehousing	Acquisitions journal Sales journal General journal	Inventories	Cost of goods sold
Capital acquisition and repayment	Acquisitions journal Cash disbursements journal General journal	Cash in bank Notes payable Long-term notes payable Accrued interest Capital stock Capital in excess of par value Retained earnings Dividends Dividends payable	Interest expense

S = Selling expense; A = general and administrative expense.

Figure 6-4 illustrates the application of cycles to audits using the December 31, 2013, trial balance for Hillsburg Hardware Company. (The financial statements prepared from this trial balance are included in the glossy insert to the textbook.) A trial balance is used to prepare financial statements and is a primary focus of every audit. Prior-year account balances are usually included for comparative purposes, but are excluded from Figure 6-4 in order to focus on transaction cycles. The letter representing a cycle is shown for each account in the left column beside the account name.

Observe that each account has at least one cycle associated with it, and only cash and inventory are a part of two or more cycles.

The accounts for Hillsburg Hardware Co. are summarized in Table 6-1 (p. 171) by cycle, and include the related journals and financial statements in which the accounts appear. The following observations expand on the information contained in Table 6-1.

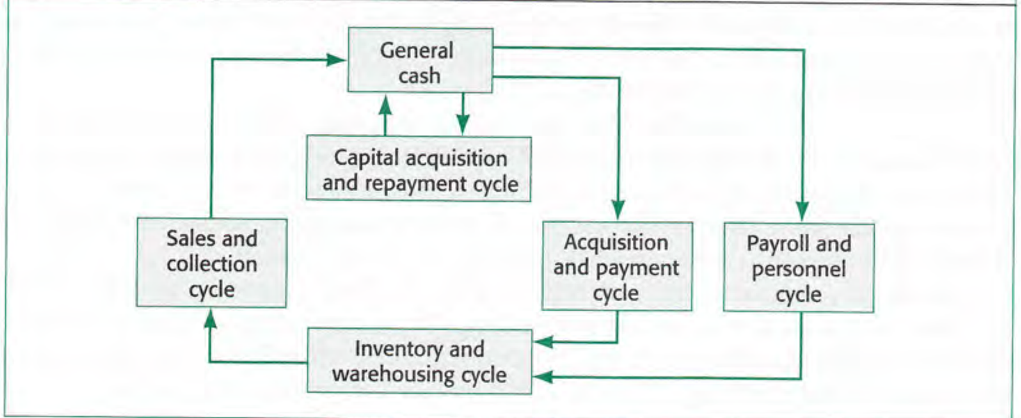
- All general ledger accounts and journals for Hillsburg Hardware Co. are included at least once. For a different company, the number and titles of journals and general ledger accounts will differ, but all will be included.
- Some journals and general ledger accounts are included in more than one cycle. When that occurs, it means that the journal is used to record transactions from more than one cycle and indicates a tie-in between the cycles. The most important general ledger account included in and affecting several cycles is general cash (cash in bank). General cash connects most cycles.
- The sales and collection cycle is the first cycle listed and is a primary focus on most audits. Collections on trade accounts receivable in the cash receipts journal is the primary operating inflow to cash in the bank.
- The capital acquisition and repayment cycle is closely related to the acquisition and payment cycle. Transactions in the acquisition and payment cycle include the purchase of inventory, supplies, and other goods and services related to operations. Transactions in the capital acquisition and repayment cycle are related to financing the business, such as issuing stock or debt, paying dividends, and repaying debt.

  Although the same journals are used for transactions in the acquisition and payment and capital acquisition and repayment cycles, it is useful to separate capital acquisition and repayment cycle transactions into a separate transaction cycle. First, capital acquisitions and repayments relate to financing the business, rather than operations. Second, most capital acquisition and repayment cycle accounts involve few transactions, but each is often highly material and therefore should be audited extensively. Considering both reasons, it is more convenient to separate the two cycles.
- The inventory and warehousing cycle is closely related to all other cycles, especially for a manufacturing company. The cost of inventory includes raw materials (acquisition and payment cycle), direct labor (payroll and personnel cycle), and manufacturing overhead (acquisition and payment and payroll and personnel cycles). The sale of finished goods involves the sales and collection cycle. Because inventory is material for most manufacturing companies, it is common to borrow money using inventory as security. In those cases, the capital acquisition and repayment cycle is also related to inventory and warehousing. Inventory is included as a separate cycle both because it is related to other cycles and because for most manufacturing and retail companies inventory is usually highly material, there are unique systems and controls for inventory, and inventory is often complex to audit.

Relationships Among Cycles

Figure 6-5 illustrates the relationships of the five cycles and general cash. Note that cycles have no beginning or end except at the origin and final disposition of a company. A company begins by obtaining capital, usually in the form of cash. In a manufacturing company, cash is used to acquire raw materials, fixed assets, and related goods and services to produce inventory (acquisition and payment cycle). Cash is also used to acquire labor for the same reason (payroll and personnel cycle). Acquisition and payment and payroll and personnel are similar in nature, but the functions are sufficiently different to justify separate cycles. The combined result of these two cycles is inventory (inventory and warehousing cycle). At a subsequent point, the inventory is sold and billings and collections result (sales and collection cycle). The cash generated is used to pay dividends and interest or finance capital expansion and to start the cycles again. The cycles interrelate in much the same way in a service company, where there will be billings and collections, although there will be no inventory.

FIGURE 6-5 **Relationships Among Transaction Cycles**



Transaction cycles are an important way to organize audits. For the most part, auditors treat each cycle separately during the audit. Although auditors need to consider the interrelationships between cycles, they typically treat cycles independently to the extent practical to manage complex audits effectively.

SETTING AUDIT OBJECTIVES

OBJECTIVE 6-5

Describe why the auditor obtains a combination of assurance by auditing classes of transactions and ending balances in accounts, including presentation and disclosure.

Auditors conduct financial statement audits using the cycle approach by performing audit tests of the transactions making up ending balances and also by performing audit tests of the account balances and related disclosures. Figure 6-6 illustrates this concept by showing the four classes of transactions that determine the ending balance in accounts receivable for Hillsburg Hardware Co. Assume that the beginning balance of $17,521 (thousand) was audited in the prior year and is therefore considered fairly stated. If the auditor could be completely sure that each of the four classes of transactions is correctly stated, the auditor could also be sure that the ending balance of $20,197 (thousand) is correctly stated. But it is almost always impractical for the auditor to obtain complete assurance about the correctness of each class of transactions, resulting in less than complete assurance about the ending balance in accounts receivable. In almost all audits, overall assurance can be increased by also auditing the ending balance of accounts receivable. Auditors have found that, generally, the most efficient and effective way to conduct audits is to *obtain some combination of assurance for each class of transactions and for the ending balance in the related accounts.*

FIGURE 6-6 **Balances and Transactions Affecting Those Balances for Accounts Receivable**

Accounts Receivable (in thousands)

Beginning balance	$ 17,521		
Sales	$144,328	$137,087	Cash receipts
		$ 1,242	Sales returns and allowances
		$ 3,323	Charge-off of uncollectible accounts
Ending balance	$ 20,197		

For any given class of transactions, several audit objectives must be met before the auditor can conclude that the transactions are properly recorded. These are called **transaction-related audit objectives** in the remainder of this book. For example, there are specific sales transaction-related audit objectives and specific sales returns and allowances transaction-related audit objectives.

Similarly, several audit objectives must be met for each account balance. These are called **balance-related audit objectives**. For example, there are specific accounts receivable balance-related audit objectives and specific accounts payable balance-related audit objectives. We show later in this chapter that the transaction-related and balance-related audit objectives are somewhat different but closely related.

The third category of audit objectives relates to the presentation and disclosure of information in the financial statements. These are called **presentation and disclosure-related audit objectives**. For example, there are specific presentation and disclosure-related audit objectives for accounts receivable and notes payable.

Throughout this text, the term *audit objectives* refers to transaction-related, balance-related, and presentation and disclosure-related audit objectives. Before examining audit objectives in more detail, we first deal with management assertions.

MANAGEMENT ASSERTIONS

OBJECTIVE 6-6

Distinguish among the three categories of management assertions about financial information.

Management assertions are implied or expressed representations by management about classes of transactions and the related accounts and disclosures in the financial statements. In most cases they are implied. Examine Figure 6-4 on page 170. Management of Hillsburg Hardware Co. asserts that cash of $827,568 was present in the company's bank accounts as of the balance sheet date. Unless otherwise disclosed in the financial statements, management also asserts that the cash was unrestricted and available for normal use. Management also asserts that all required disclosures related to cash are accurate and are understandable. Similar assertions exist for each asset, liability, owners' equity, revenue, and expense item in the financial statements. These assertions apply to classes of transactions, account balances, and presentation and disclosures.

Management assertions are directly related to the financial reporting framework used by the company (usually U.S. GAAP or IFRS), as they are part of the *criteria that management uses to record and disclose accounting information in financial statements.* The definition of auditing in Chapter 1, in part, states that auditing is a comparison of information (financial statements) to established criteria (assertions established according to accounting standards). Auditors must therefore understand the assertions to do adequate audits.

International auditing standards and AICPA auditing standards classify assertions into three categories:

1. Assertions about classes of transactions and events for the period under audit
2. Assertions about account balances at period end
3. Assertions about presentation and disclosure

The specific assertions included in each category are included in Table 6-2. The assertions are grouped so that assertions related across categories of assertions are included on the same table row.

Assertions About Classes of Transactions and Events

Management makes several assertions about transactions. These assertions also apply to other events that are reflected in the accounting records, such as recording depreciation and recognizing pension obligations.

Occurrence The occurrence assertion concerns whether recorded transactions included in the financial statements actually occurred during the accounting period. For example, management asserts that recorded sales transactions represent exchanges of goods or services that actually took place.

TABLE 6-2	Management Assertions for Each Category of Assertions	
Assertions About Classes of Transactions and Events	**Assertions About Account Balances**	**Assertions About Presentation and Disclosure**
Occurrence—Transactions and events that have been recorded have occurred and pertain to the entity.	*Existence*—Assets, liabilities, and equity interests exist.	*Occurrence and rights and obligations*—Disclosed events and transactions have occurred and pertain to the entity.
Completeness—All transactions and events that should have been recorded have been recorded.	*Completeness*—All assets, liabilities, and equity interests that should have been recorded have been recorded.	*Completeness*—All disclosures that should have been included in the financial statements have been included.
Accuracy—Amounts and other data relating to recorded transactions and events have been recorded appropriately.	*Valuation and allocation*—Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation adjustments are appropriately recorded.	*Accuracy and valuation*—Financial and other information are disclosed appropriately and at appropriate amounts.
Classification—Transactions and events have been recorded in the proper accounts.		*Classification and understandability*—Financial and other information is appropriately presented and described and disclosures are clearly expressed.
Cutoff—Transactions and events have been recorded in the correct accounting period.		
	Rights and obligations—The entity holds or controls the rights to assets, and liabilities are the obligation of the entity.	

Understand objectives and responsibilities for the audit

Divide financial statements into cycles

Know management assertions about financial statements

Know general audit objectives for classes of transactions, accounts, and disclosures

Know specific audit objectives for classes of transactions, accounts, and disclosures

Completeness This assertion addresses whether all transactions that should be included in the financial statements are in fact included. For example, management asserts that all sales of goods and services are recorded and included in the financial statements.

The completeness assertion addresses matters opposite from the occurrence assertion. The completeness assertion is concerned with the possibility of omitting transactions that should have been recorded, whereas the occurrence assertion is concerned with inclusion of transactions that should not have been recorded. Thus, violations of the occurrence assertion relate to account overstatements, whereas violations of the completeness assertion relate to account understatements. The recording of a sale that did not take place is a violation of the occurrence assertion, whereas the failure to record a sale that did occur is a violation of the completeness assertion.

Accuracy The accuracy assertion addresses whether transactions have been recorded at correct amounts. Using the wrong price to record a sales transaction and an error in calculating the extensions of price times quantity are examples of violations of the accuracy assertion.

Classification The classification assertion addresses whether transactions are recorded in the appropriate accounts. Recording administrative salaries in cost of sales is one example of a violation of the classification assertion.

Cutoff The cutoff assertion addresses whether transactions are recorded in the proper accounting period. Recording a sales transaction in December when the goods were not shipped until January violates the cutoff assertion.

Assertions About Account Balances

Assertions about account balances at year-end address existence, completeness, valuation and allocation, and rights and obligations.

Existence The existence assertion deals with whether assets, liabilities, and equity interests included in the balance sheet actually existed on the balance sheet date. For example, management asserts that merchandise inventory included in the balance sheet exists and is available for sale at the balance sheet date.

Completeness This assertion addresses whether all accounts and amounts that should be presented in the financial statements are in fact included. For example, management asserts that notes payable in the balance sheet include all such obligations of the entity.

The completeness assertion addresses matters opposite from the existence assertion. The completeness assertion is concerned with the possibility of omitting items from the financial statements that should have been included, whereas the existence assertion is concerned with inclusion of amounts that should not have been included. Thus, violations of the existence assertion relate to account overstatements, whereas violations of the completeness assertion relate to account understatements. Inclusion of a receivable for a customer that does not exist violates the existence assertion, whereas the failure to include a receivable from a customer violates the completeness assertion.

Valuation and Allocation The valuation and allocation assertion deals with whether assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, including any valuation adjustments to reflect asset amounts at fair value or net realizable value. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods through depreciation. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.

Rights and Obligations This assertion addresses whether assets are the rights of the entity and whether liabilities are the obligations of the entity at a given date. For example, management asserts that assets are owned by the company or that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

Assertions About Presentation and Disclosure

With increases in the complexity of transactions and the need for expanded disclosures about these transactions, assertions about presentation and disclosure have increased in importance. These assertions include occurrence and rights and obligations, completeness, accuracy and valuation, and classification and understandability.

Occurrence and Rights and Obligations This assertion addresses whether disclosed events have occurred and are the rights and obligations of the entity. For example, if the client discloses that it has acquired another company, it asserts that the transaction has been completed.

Completeness This assertion deals with whether all required disclosures have been included in the financial statements. As an example, management asserts that all material transactions with related parties have been disclosed in the financial statements.

Accuracy and Valuation The accuracy and valuation assertion deals with whether financial information is disclosed fairly and at appropriate amounts. Management's disclosure of the amount of unfunded pension obligations and the assumptions underlying these amounts is an example of this assertion.

PCAOB ASSERTIONS

As noted in Chapter 2, the PCAOB establishes auditing standards for audits of U.S. public companies. PCAOB Auditing Standard No. 10 classifies management assertions into five categories:

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

These assertions are similar to the assertions in the AICPA auditing standards, as the first three assertions are applicable to account balances and classes of transactions. Presentation and disclosure is treated as a single assertion.

Source: Based on the 2002 U.S. Auditing Standards issued by the AICPA Auditing Standards Board Public Company Accounting Oversight Board (www.pcaobus.org/Standards/Auditing).

Classification and Understandability This assertion relates to whether amounts are appropriately classified in the financial statements and footnotes, and whether the balance descriptions and related disclosures are understandable. For example, management asserts that the classification of inventories as finished goods, work-in-process, and raw materials is appropriate, and the disclosures of the methods used to value inventories are understandable.

Auditors may use different terms to express the management assertions as long as all the aspects included in Table 6-2 (p. 175) are addressed. The auditor should consider the relevance of each assertion for each significant class of transactions, account balance, and presentation and disclosure. **Relevant assertions** have a meaningful bearing on whether the account is fairly stated and are used to assess the risk of material misstatement and the design and performance of audit procedures. For example, valuation is likely to be a relevant assertion for accounts receivable, but not for cash.

After the relevant assertions have been identified, the auditor can then develop audit objectives for each category of assertions. The auditor's audit objectives follow and are closely related to management assertions. That is not surprising because the auditor's primary responsibility is to determine whether management assertions about financial statements are justified. The reason for using audit objectives, rather than the assertions, is to provide a framework to help the auditor accumulate sufficient appropriate evidence and decide the proper evidence to accumulate given the circumstances of the engagement. The objectives remain the same from audit to audit, but the evidence varies depending on the circumstances.

TRANSACTION-RELATED AUDIT OBJECTIVES

OBJECTIVE 6-7

Link the six general transaction-related audit objectives to management assertions for classes of transactions.

The auditor's transaction-related audit objectives follow and are closely related to management's assertions about classes of transactions. There is a difference between general transaction-related audit objectives and specific transaction-related audit objectives for each class of transactions. The six general transaction-related audit objectives discussed here are applicable to every class of transactions and are stated in broad terms. Specific transaction-related audit objectives are also applied to each class of transactions but are stated in terms tailored to a specific class of transactions, such as sales transactions. Once the auditor establishes general transaction-related audit objectives, they can be used to develop specific transaction-related audit objectives for each class of transactions being audited.

General Transaction-Related Audit Objectives

Occurrence—Recorded Transactions Exist This objective deals with whether recorded transactions have actually occurred. Inclusion of a sale in the sales journal when no sale occurred violates the occurrence objective. This objective is the auditor's counterpart to the management assertion of occurrence for classes of transactions.

Completeness—Existing Transactions Are Recorded This objective deals with whether all transactions that should be included in the journals have actually been included. Failure to include a sale in the sales journal and general ledger when a sale occurred violates the completeness objective. This objective is the counterpart to the management assertion of completeness for classes of transactions.

The occurrence and completeness objectives emphasize opposite audit concerns. Occurrence deals with potential overstatement; completeness deals with unrecorded transactions (understatement).

Accuracy—Recorded Transactions Are Stated at the Correct Amounts This objective addresses the accuracy of information for accounting transactions and is one part of the accuracy assertion for classes of transactions. For sales transactions, this objective is violated if the quantity of goods shipped was different from the quantity billed, the wrong selling price was used for billing, extension or adding errors occurred in billing, or the wrong amount was included in the sales journal.

TABLE 6-3 **Hillsburg Hardware Co.: Management Assertions and Transaction-Related Audit Objectives Applied to Sales Transactions**

Management Assertions About Classes of Transactions and Events	General Transaction-Related Audit Objectives	Specific Sales Transaction-Related Audit Objectives
Occurrence	Occurrence	Recorded sales are for shipments made to nonfictitious customers.
Completeness	Completeness	Existing sales transactions are recorded.
Accuracy	Accuracy	Recorded sales are for the amount of goods shipped and are correctly billed and recorded.
	Posting and summarization	Sales transactions are properly included in the master file and are correctly summarized.
Classification	Classification	Sales transactions are properly classified.
Cutoff	Timing	Sales transactions are recorded on the correct dates.

It is important to distinguish between accuracy and occurrence or completeness. For example, if a recorded sales transaction should not have been recorded because the shipment was on consignment, the occurrence objective has been violated, even if the amount of the invoice was accurately calculated. If the recorded sale was for a valid shipment but the amount was calculated incorrectly, there is a violation of the accuracy objective but not of occurrence. The same relationship exists between completeness and accuracy.

Understand objectives and responsibilities for the audit

Divide financial statements into cycles

Know management assertions about financial statements

Know general audit objectives for classes of transactions, accounts, and disclosures

Know specific audit objectives for classes of transactions, accounts, and disclosures

Posting and Summarization—Recorded Transactions Are Properly Included in the Master Files and Are Correctly Summarized This objective deals with the accuracy of the transfer of information from recorded transactions in journals to subsidiary records and the general ledger. It is part of the accuracy assertion for classes of transactions. For example, if a sales transaction is recorded in the wrong customer's record or at the wrong amount in the master file or the sum of all sales transactions posted from the sales journal to the general ledger is inaccurate, this objective is violated. Because the posting of transactions from journals to subsidiary records, the general ledger, and other related master files is typically accomplished automatically by computerized accounting systems, the risk of random human error in posting is minimal. Once the auditor can establish that the computer is functioning properly, there is a reduced concern about posting process errors.

Classification—Transactions Included in the Client's Journals Are Properly Classified As the auditor's counterpart to management's classification assertion for classes of transaction, this objective addresses whether transactions are included in the appropriate accounts. Examples of misclassifications for sales are: including cash sales as credit sales, recording a sale of operating fixed assets as revenue, and misclassifying commercial sales as residential sales.

Timing—Transactions Are Recorded on the Correct Dates The timing objective for transactions is the auditor's counterpart to management's cutoff assertion. A timing error occurs if a transaction is not recorded on the day it took place. A sales transaction, for example, should be recorded on the date of shipment.

Specific Transaction-Related Audit Objectives

After the general transaction-related audit objectives are determined, specific transaction-related audit objectives for each material class of transactions can be developed. Such classes of transactions typically include sales, cash receipts, acquisitions of goods and services, payroll, and so on. At least one specific transaction-related audit objective should be included for each general transaction-related audit objective unless the auditor believes that the general transaction-related audit objective is not relevant or is unimportant in the circumstances.

Relationships Among Management Assertions and Transaction-Related Audit Objectives

Table 6-3 illustrates the relationships among management assertions, the general transaction-related audit objectives, and specific transaction-related audit objectives as applied to sales for Hillsburg Hardware Co. Notice that there is a one-to-one relationship between assertions and objectives, except for the accuracy assertion. The accuracy assertion has two objectives because of the need to provide auditors with guidance in testing transaction accuracy.

BALANCE-RELATED AUDIT OBJECTIVES

OBJECTIVE 6-8

Link the eight general balance-related audit objectives to management assertions for account balances.

Balance-related audit objectives are similar to the transaction-related audit objectives just discussed. They also follow from management assertions and they provide a framework to help the auditor accumulate sufficient appropriate evidence related to account balances. There are also both general and specific balance-related audit objectives.

There are two differences between balance-related and transaction-related audit objectives. First, as the terms imply, balance-related audit objectives are applied to account balances such as accounts receivable and inventory rather than classes of transactions such as sales transactions and purchases of inventory. Second, there are eight balance-related audit objectives compared to six transaction-related audit objectives.

Because of the way audits are performed, balance-related audit objectives are almost *always* applied to the ending balance in balance sheet accounts, such as accounts receivable, inventory, and notes payable. However, some balance-related audit objectives are applied to certain income statement accounts. These usually involve nonroutine transactions and unpredictable expenses, such as legal expense or repairs and maintenance. Other income statement accounts are closely related to balance sheet accounts and are tested simultaneously, such as depreciation expense with accumulated depreciation and interest expense with notes payable.

When using the balance-related audit objectives to audit account balances, the auditor accumulates evidence to verify detail that supports the account balance, rather than verifying the account balance itself. For example, in auditing accounts receivable, the auditor obtains a listing of the accounts receivable master file that agrees to the general ledger balance (see page 545 for an illustration). The accounts receivable balance-related audit objectives are applied to the customer accounts in that listing.

General Balance-Related Audit Objectives

Throughout the following discussion of the eight balance-related audit objectives, we make references to a supporting schedule, by which we mean a client-provided schedule or electronic file, such as the list of accounts receivable just discussed.

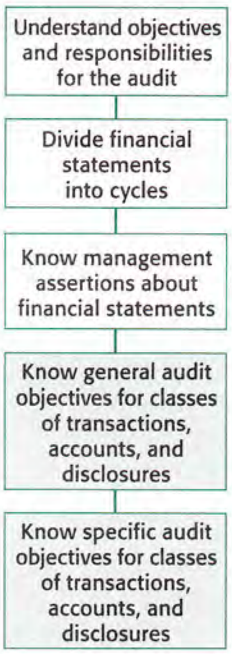
Existence—Amounts Included Exist This objective deals with whether the amounts included in the financial statements should actually be included. For example, inclusion of an account receivable from a customer in the accounts receivable trial balance when there is no receivable from that customer violates the existence objective. This objective is the auditor's counterpart to the management assertion of existence for account balances.

Completeness—Existing Amounts Are Included This objective deals with whether all amounts that should be included have actually been included. Failure to include an account receivable from a customer in the accounts receivable trial balance when a receivable exists violates the completeness objective. This objective is the counterpart to the management assertion of completeness for account balances.

The existence and completeness objectives emphasize opposite audit concerns. Existence deals with potential overstatement; completeness deals with unrecorded amounts (understatement).

Accuracy—Amounts Included Are Stated at the Correct Amounts The accuracy objective refers to amounts being included at the correct amount. An inventory item on a client's inventory listing can be wrong because the number of units of inventory on hand was misstated, the unit price was wrong, or the total was incorrectly extended. Each of these violates the accuracy objective. Accuracy is one part of the valuation and allocation assertion for account balances.

Classification—Amounts Included in the Client's Listing are Properly Classified Classification involves determining whether items included on a client's listing are included in the correct general ledger accounts. For example, on the accounts receivable listing, receivables must be separated into short-term and long-term, and amounts due from affiliates, officers, and directors must be classified separately from amounts due from customers. Classification is also part of the valuation and allocation assertion. The classification balance-related audit objective is closely related to the presentation and disclosure-related audit objectives, but relates to how balances are classified in general ledger accounts so they can be appropriately presented and disclosed in the financial statements.



Cutoff—Transactions Near the Balance Sheet Date Are Recorded in the Proper Period In testing for cutoff of account balances, the auditor's objective is to determine whether transactions are recorded and included in account balances in the proper period. An account balance is likely to be misstated by those transactions recorded near the end of the accounting period. For an annual audit this is as of the balance sheet date. Cutoff tests can be thought of as a part of verifying either the balance sheet accounts or the related transactions, but for convenience, auditors usually perform them as a part of auditing balance sheet accounts. For this reason, we also include cutoff as a balance-related audit objective related to the valuation and allocation assertion for account balances. The timing objective for transactions deals with the proper timing of recording transactions throughout the year, whereas the cutoff objective for balance-related audit objectives relates only to transactions near year-end. For example, in a December 31 year-end audit, a sales transaction recorded in March for a February shipment is a transaction-related audit objective error, but not a balance-related audit objective error.

Detail Tie-In—Details in the Account Balance Agree with Related Master File Amounts, Foot to the Total in the Account Balance, and Agree with the Total in the General Ledger Account balances on financial statements are supported by details in master files and schedules prepared by clients. The detail tie-in objective is concerned that the details on lists are accurately prepared, correctly added, and agree with the general ledger. For example, individual accounts receivable on a listing of accounts receivable should be the same in the accounts receivable master file, and the total should equal the general ledger control account. Detail tie-in is also a part of the valuation and allocation assertion for account balances.

Realizable Value—Assets Are Included at the Amounts Estimated to Be Realized This objective concerns whether an account balance has been reduced for declines from historical cost to net realizable value or when accounting standards require fair market value accounting treatment. Examples when the objective applies are considering the adequacy of the allowance for uncollectible accounts receivable and write-downs of inventory for obsolescence. The objective generally applies only to asset accounts, although some liabilities are recorded at fair value, and is also a part of the valuation and allocation assertion for account balances.

Rights and Obligations In addition to existing, most assets must be owned before it is acceptable to include them in the financial statements. Similarly, liabilities must belong to the entity. Rights are always associated with assets and obligations with liabilities. This objective is the auditor's counterpart to the management assertion of rights and obligations for account balances.

Specific Balance-Related Audit Objectives

The same as for transaction-related audit objectives, after the general balance-related audit objectives are determined, specific balance-related audit objectives for each account balance on the financial statements can be developed. At least one specific balance-related audit objective should be included for each general balance-related audit objective unless the auditor believes that the general balance-related audit objective is not relevant or is unimportant for the account balance being considered. There may be more than one specific balance-related audit objective for a general balance-related audit objective. For example, specific balance-related audit objectives for rights and obligations of the inventory of Hillsburg Hardware Co. could include (1) the company has title to all inventory items listed and (2) inventory is not pledged as collateral for a loan unless it is disclosed.

Relationships Among Management Assertions and Balance-Related Audit Objectives

Table 6-4 illustrates the relationships among management assertions, the general balance-related audit objectives, and specific balance-related audit objectives as applied to inventory for Hillsburg Hardware Co. Notice that there is a one-to-one relationship between assertions and objectives, except for the valuation and allocation assertion. The valuation and allocation assertion has multiple objectives because of the complexity of valuation issues and the need to provide auditors with additional guidance for testing valuation.

TABLE 6-4 **Hillsburg Hardware Co.: Management Assertions and Balance-Related Audit Objectives Applied to Inventory**

Management Assertions About Account Balances	General Balance-Related Audit Objectives	Specific Balance-Related Audit Objectives Applied to Inventory
Existence	Existence	All recorded inventory exists at the balance sheet date.
Completeness	Completeness	All existing inventory has been counted and included in the inventory summary.
Valuation and allocation	Accuracy	Inventory quantities on the client's perpetual records agree with items physically on hand. Prices used to value inventories are materially correct. Extensions of price times quantity are correct and details are correctly added.
	Classification	Inventory items are properly classified as to raw materials, work in process, and finished goods.
	Cutoff	Purchase cutoff at year-end is proper. Sales cutoff at year-end is proper.
	Detail tie-in	Total of inventory items agrees with general ledger.
	Realizable value	Inventories have been written down where net realizable value is impaired.
Rights and obligations	Rights and obligations	The company has title to all inventory items listed. Inventories are not pledged as collateral.

PRESENTATION AND DISCLOSURE-RELATED AUDIT OBJECTIVES

OBJECTIVE 6-9

Link the four presentation and disclosure-related audit objectives to management assertions for presentation and disclosure.

The presentation and disclosure-related audit objectives are identical to the management assertions for presentation and disclosure discussed previously. The same concepts that apply to balance-related audit objectives apply equally to presentation and disclosure audit objectives. Table 6-5 includes the management assertions about presentation and disclosure, related general presentation and disclosure-related audit objectives, and specific audit objectives for notes payable for Hillsburg Hardware Co.

HOW AUDIT OBJECTIVES ARE MET

OBJECTIVE 6-10

Explain the relationship between audit objectives and the accumulation of audit evidence.

The auditor must obtain sufficient appropriate audit evidence to support all management assertions in the financial statements. This is done by accumulating evidence in support of some appropriate combination of transaction-related audit objectives and balance-related audit objectives. A comparison of Tables 6-3 (p. 178) and 6-4 (p. 181) illustrates the significant overlap between the transaction-related and balance-related audit objectives. Rights and obligations is the only balance-related assertion without a similar transaction-related assertion. Presentation and disclosure-related audit objectives are closely related to the balance-related audit objectives. Auditors often consider presentation and disclosure audit objectives when addressing the balance-related audit objectives.

The auditor must decide the appropriate audit objectives and the evidence to accumulate to meet those objectives on every audit. To do this, auditors follow an audit process, which is a well-defined methodology for organizing an audit to ensure that the evidence gathered is both sufficient and appropriate and that all required audit objectives are both specified and met. If the client is an accelerated filer public company, the auditor must also plan to meet the objectives associated with reporting on the effectiveness of internal control over financial reporting. PCAOB Auditing Standard 5 requires that the audit of the effectiveness of internal control be integrated

TABLE 6-5 Hillsburg Hardware Co.: Management Assertions and Presentation and Disclosure-Related Audit Objectives Applied to Notes Payable

Management Assertions About Presentation and Disclosure	General Presentation- and Disclosure-Related Audit Objectives	Specific Presentation and Disclosure-Related Audit Objectives Applied to Notes Payable
Occurrence and rights and obligations	Occurrence and rights and obligations	Notes payable as described in the footnotes exist and are obligations of the company.
Completeness	Completeness	All required disclosures related to notes payable are included in the financial statement footnotes.
Accuracy and valuation	Accuracy and valuation	Footnote disclosures related to notes payable are accurate.
Classification and understandability	Classification and understandability	Notes payable are appropriately classified as to short-term and long-term obligations, and related financial statement disclosures are understandable.

FIGURE 6-7 **Four Phases of a Financial Statement Audit**

Phase I	Plan and design an audit approach based on risk assessment procedures
Phase II	Perform tests of controls and substantive tests of transactions
Phase III	Perform analytical procedures and tests of details of balances
Phase IV	Complete the audit and issue an audit report

with the audit of the financial statements. The audit process, as described in this text, has four specific phases, as shown in Figure 6-7. The rest of this chapter provides a brief introduction to each of the four **phases of the audit process**.

Plan and Design an Audit Approach (Phase I)

For any given audit, there are many ways in which an auditor can accumulate evidence to meet the overall audit objective of providing an opinion on the financial statements. Two overriding considerations affect the approach the auditor selects:

1. Sufficient appropriate evidence must be accumulated to meet the auditor's professional responsibility.
2. The cost of accumulating the evidence should be minimized.

The first consideration is the most important, but cost minimization is necessary if CPA firms are to be competitive and profitable. If there were no concern for controlling costs, evidence decision making would be easy. Auditors would keep adding evidence, without concern for efficiency, until they were sufficiently certain that there were no material misstatements.

Concern for sufficient appropriate evidence and cost control necessitates planning the engagement. The plan should result in an effective audit approach at a reasonable cost. The auditor performs procedures to assess the risk that material misstatements in the financial statements may be present. Those risk assessment procedures are a critical component to planning and designing an audit approach, which can be broken down into several parts. Three key aspects are introduced here and are discussed in subsequent chapters.

Obtain An Understanding of the Entity and its Environment To adequately assess the risk of misstatements in the financial statements and to interpret information obtained throughout the audit, the auditor must have a thorough understanding of the client's business and related environment, including knowledge of strategies and processes. The auditor should study the client's business model, perform analytical procedures and make comparisons to competitors. The auditor must also understand any unique accounting requirements of the client's industry. For example, when auditing an insurance company, the auditor must understand how loss reserves are calculated.

Understand Internal Control and Assess Control Risk The risk of misstatement in the financial statements is reduced if the client has effective controls over computer operations and transaction processing. In Chapter 2, we discussed how the ability of the client's internal controls to generate reliable financial information and safeguard assets and records is one of the most important and widely accepted concepts in the theory and practice of auditing. The auditor identifies internal controls and evaluates their effectiveness, a process called *assessing control risk*. If internal controls are considered effective, planned assessed control risk can be reduced and the amount of audit evidence to be accumulated can be significantly less than when internal controls are not adequate.

Assess Risk of Material Misstatement The auditor uses the understanding of the client's industry and business strategies, as well as the effectiveness of controls, to assess the risk of misstatements in the financial statements. This assessment will then impact the audit plan and the nature, timing, and extent of audit procedures. For example, if the client is expanding sales by taking on new customers with poor credit ratings, the auditor will assess a higher risk of misstatement for net realizable value of accounts receivable and plan to expand testing in this area.

Perform Tests of Controls and Substantive Tests of Transactions (Phase II)

Before auditors can justify reducing planned assessed control risk when internal controls are believed to be effective, they must first test the effectiveness of the controls. The procedures for this type of testing are commonly referred to as **tests of controls.** For example, assume a client's internal controls require computer matching of all relevant terms on the customer sales order, shipping document, and sales invoice before sales invoices are transmitted to customers. This control is directly related to the occurrence and accuracy transaction-related audit objectives for sales. The auditor might test the effectiveness of this control by comparing a sample of sales invoices to related shipping documents and customer sales orders, or by performing tests of the computerized controls related to this process.

Auditors also evaluate the client's recording of transactions by verifying the monetary amounts of transactions, a process called **substantive tests of transactions.** For example, the auditor might use computer software to compare the unit selling price on duplicate sales invoices with an electronic file of approved prices as a test of the accuracy objective for sales transactions. Like the test of control in the preceding paragraph, this test satisfies the accuracy transaction-related audit objective for sales. For the sake of efficiency, auditors often perform tests of controls and substantive tests of transactions at the same time.

Perform Analytical Procedures and Tests of Details of Balances (Phase III)

There are two general categories of phase III procedures. **Analytical procedures** consist of evaluations of financial information through analysis of plausible relationships among financial and nonfinancial data. For example, to provide some assurance for the accuracy objective for both sales transactions (transaction-related audit objective) and accounts receivable (balance-related audit objective), the auditor might examine sales transactions in the sales journal for unusually large amounts and also compare total monthly sales with prior years. If a company is consistently using incorrect sales prices or improperly recording sales, significant differences are likely.

Tests of details of balances are specific procedures intended to test for monetary misstatements in the balances in the financial statements. An example related to the accuracy objective for accounts receivable (balance-related audit objective) is direct, written communication with the client's customers to identify incorrect amounts. Tests of details of ending balances are essential to the conduct of the audit because much of the evidence is obtained from third-party sources and therefore is considered to be of high quality.

Complete the Audit and Issue an Audit Report (Phase IV)

After the auditor has completed all procedures for each audit objective and for each financial statement account and related disclosures, it is necessary to combine the information obtained to reach an *overall conclusion* as to whether the financial statements are fairly presented. This highly subjective process relies heavily on the auditor's professional judgment. When the audit is completed, the CPA must issue an audit report to accompany the client's published financial statements. These reports were discussed in Chapter 3.

SUMMARY

This chapter described management's responsibility for the financial statements and internal control and the auditor's responsibility to audit the financial statements and the effectiveness of internal control over financial reporting. This chapter also discussed management assertions and the related objectives of the audit and the way the auditor subdivides an audit to result in specific audit objectives. The auditor then accumulates evidence to obtain assurance that each audit objective has been satisfied. The illustration for sales transactions and accounts receivable shows that the auditor can obtain assurance by accumulating evidence using tests of controls, substantive tests of transactions, analytical procedures, and tests of details of balances. In some audits, there is more emphasis on certain tests such as analytical procedures and tests of controls, whereas in others, there is emphasis on substantive tests of transactions and tests of details of balances.

ESSENTIAL TERMS

Analytical procedures—evaluations of financial information through analysis of plausible relationships among financial and nonfinancial data

Balance-related audit objectives—eight audit objectives that must be met before the auditor can conclude that any given account balance is fairly stated; the general balance-related audit objectives are existence, completeness, accuracy, classification, cutoff, detail tie-in, realizable value, and rights and obligations

Cycle approach—a method of dividing an audit by keeping closely related types of transactions and account balances in the same segment

Error—an unintentional misstatement of the financial statements

Fraud—an intentional misstatement of the financial statements

Fraudulent financial reporting—intentional misstatements or omissions of amounts or disclosures in financial statements to deceive users; often called management fraud

Management assertions—implied or expressed representations by management about classes of transactions, related account balances, and presentation and disclosures in the financial statements

Misappropriation of assets—a fraud involving the theft of an entity's assets; often called defalcation

Noncompliance with laws and regulations—failure to comply with applicable laws and regulations; often referred to as illegal acts

Phases of the audit process—the four aspects of a complete audit: (1) plan and design an audit approach, (2) perform tests of controls and substantive tests of transactions, (3) perform analytical procedures and tests of details of balances, and (4) complete the audit and issue an audit report

Presentation and disclosure-related audit objectives—four audit objectives that must be met before the auditor can conclude that presentation and disclosures are fairly stated; the four presentation and disclosure-related audit objectives are occurrence and rights and obligations, completeness, accuracy and valuation, and classification and understandability

Relevant assertions—assertions that have a meaningful bearing on whether an account is fairly stated and used to assess the risk of material misstatement and the design and performance of audit procedures

Substantive tests of transactions—audit procedures testing for monetary misstatements to determine whether the six transaction-related audit objectives have been satisfied for each class of transactions

Tests of controls—audit procedures to test the effectiveness of controls in support of a reduced assessed control risk

Tests of details of balances—audit procedures testing for monetary misstatements to determine whether the eight balance-related audit objectives have been satisfied for each significant account balance

Transaction-related audit objectives—six audit objectives that must be met before the auditor can conclude that the total for any given class of transactions is fairly stated; the general transaction-related audit objectives are occurrence, completeness, accuracy, classification, timing, and posting and summarization

REVIEW QUESTIONS

6-1 (Objective 6-1) State the objective of the audit of financial statements. In general terms, how do auditors meet that objective?

6-2 (Objectives 6-2, 6-3) Distinguish between management's and the auditor's responsibility for the financial statements being audited.

6-3 (Objective 6-3) Distinguish between the terms *errors* and *fraud*. What is the auditor's responsibility for finding each?

6-4 (Objective 6-3) Distinguish between fraudulent financial reporting and misappropriation of assets. Discuss the likely difference between these two types of fraud on the fair presentation of financial statements.

6-5 (Objective 6-3) List two major characteristics that are useful in predicting the likelihood of fraudulent financial reporting in an audit. For each of the characteristics, state two things that the auditor can do to evaluate its significance in the engagement.

6-6 (Objective 6-3) Explain the auditor's responsibility to consider compliance with laws and regulations. How does this responsibility differ for laws and regulations that have a direct effect on the financial statements compared to other laws and regulations that do not have a direct effect?

6-7 (Objective 6-3) What is the auditor's responsibility when noncompliance with laws or regulations is identified or suspected?

6-8 (Objective 6-4) Describe what is meant by the cycle approach to auditing. What are the advantages of dividing the audit into different cycles?

6-9 (Objective 6-4) Identify the cycle to which each of the following general ledger accounts will ordinarily be assigned: sales, accounts payable, retained earnings, accounts receivable, inventory, and repairs and maintenance.

6-10 (Objectives 6-4, 6-5) Why are sales, sales returns and allowances, bad debts, cash discounts, accounts receivable, and allowance for uncollectible accounts all included in the same cycle?

6-11 (Objective 6-6) Define what is meant by a management assertion about financial statements. Identify the three broad categories of management assertions.

6-12 (Objectives 6-5, 6-6) Distinguish between the general audit objectives and management assertions. Why are the general audit objectives more useful to auditors?

6-13 (Objective 6-7) An acquisition of a fixed-asset repair by a construction company is recorded on the wrong date. Which transaction-related audit objective has been violated? Which transaction-related audit objective has been violated if the acquisition had been capitalized as a fixed asset rather than expensed?

6-14 (Objective 6-8) Distinguish between the existence and completeness balance-related audit objectives. State the effect on the financial statements (overstatement or understatement) of a violation of each in the audit of accounts receivable.

6-15 (Objectives 6-7, 6-8, 6-9) What are specific audit objectives? Explain their relationship to the general audit objectives.

6-16 (Objectives 6-6, 6-8) Identify the management assertion and general balance-related audit objective for the specific balance-related audit objective: All recorded fixed assets exist at the balance sheet date.

6-17 (Objectives 6-6, 6-8) Explain how management assertions, general balance-related audit objectives, and specific balance-related audit objectives are developed for an account balance such as accounts receivable.

6-18 (Objectives 6-6, 6-9) Identify the management assertion and presentation and disclosure-related audit objective for the specific presentation and disclosure-related audit objective: Read the fixed asset footnote disclosure to determine that the types of fixed assets, depreciation methods, and useful lives are clearly disclosed.

6-19 (Objective 6-10) Identify the four phases of the audit. What is the relationship of the four phases to the objective of the audit of financial statements?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

6-20 (Objective 6-3) The following questions deal with errors and fraud. Choose the best response.

a. An independent auditor has the responsibility to design the audit to provide reasonable assurance of detecting errors and fraud that might have a material effect on the financial statements. Which of the following, if material, is a fraud as defined in auditing standards?
   (1) Misappropriation of an asset or groups of assets.
   (2) Clerical mistakes in the accounting data underlying the financial statements.
   (3) Mistakes in the application of accounting principles.
   (4) Misinterpretation of facts that existed when the financial statements were prepared.

b. What assurance does the auditor provide that errors and fraud that are material to the financial statements will be detected?

Errors	Fraud
(1) Limited	Negative
(2) Reasonable	Reasonable
(3) Limited	Limited
(4) Reasonable	Limited

c. Which of the following statements describes why a properly designed and executed audit may not detect a material misstatement in the financial statements resulting from fraud?
   (1) Audit procedures that are effective for detecting unintentional misstatements may be ineffective for an intentional misstatement that is concealed through collusion.
   (2) An audit is designed to provide reasonable assurance of detecting material errors, but there is no similar responsibility concerning fraud.
   (3) The factors considered in assessing control risk indicated an increased risk of intentional misstatements, but only a low risk of unintentional misstatements.
   (4) The auditor did not consider factors influencing audit risk for account balances that have effects pervasive to the financial statements taken as a whole.

6-21 (Objective 6-1) The following questions concern the reasons auditors do audits. Choose the best response.

a. Which of the following best describes the reason why an independent auditor reports on financial statements?
   (1) A misappropriation of assets may exist, and it is more likely to be detected by independent auditors.
   (2) Different interests may exist between the company preparing the statements and the persons using the statements.
   (3) A misstatement of account balances may exist and is generally corrected as the result of the independent auditor's work.
   (4) Poorly designed internal controls may be in existence.

b. Because of the risk of material misstatement, an audit should be planned and performed with an attitude of
   (1) objective judgment.
   (2) independent integrity.
   (3) professional skepticism.
   (4) impartial conservatism.

c. The major reason an independent auditor gathers audit evidence is to
   (1) form an opinion on the financial statements.
   (2) detect fraud.
   (3) evaluate management.
   (4) assess control risk.

6-22 (Objective 6-6) The following questions deal with management assertions. Choose the best response.

a. An auditor reviews aged accounts receivable to assess likelihood of collection to support management's assertion about account balances of
   (1) existence.
   (2) completeness.
   (3) valuation and allocation.
   (4) rights and obligations.

b. An auditor will most likely review an entity's periodic accounting for the numerical sequence of shipping documents to ensure all documents are included to support management's assertion about classes of transactions of
   (1) occurrence.
   (2) completeness.
   (3) accuracy.
   (4) classification.

c. In the audit of accounts payable, an auditor's procedures will most likely focus primarily on management's assertion about account balances of
   (1) existence.
   (2) completeness.
   (3) valuation and allocation.
   (4) classification and understandability.

DISCUSSION QUESTIONS AND PROBLEMS

6-23 (Objectives 6-1, 6-3) Auditors provide "reasonable assurance" that the financial statements are "fairly stated, in all material respects." Questions are often raised as to the responsibility of the auditor to detect material misstatements, including misappropriation of assets and fraudulent financial reporting.

Required

a. Discuss the concept of "reasonable assurance" and the degree of confidence that financial statement users should have in the financial statements.

b. What are the responsibilities of the independent auditor in the audit of financial statements? Discuss fully, but in this part do not include fraud in the discussion.

c. What are the responsibilities of the independent auditor for the detection of fraud involving misappropriation of assets and fraudulent financial reporting? Discuss fully, including your assessment of whether the auditor's responsibility for the detection of fraud is appropriate.

6-24 (Objectives 6-2, 6-3) The following are selected portions of the report of management from a published annual report.

REPORT OF MANAGEMENT

Management's Report on Internal Control over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of its President and Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting in accordance with accounting principles generally accepted in the United States of America. Management evaluates the effectiveness of the Company's internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control–Integrated Framework*. Management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013, and concluded it is effective.

Management's Responsibility for Consolidated Financial Statements

Management is also responsible for the preparation and content of the accompanying consolidated financial statements as well as all other related information contained in this annual report. These financial statements have been prepared in conformity with accounting principles generally accepted in the United States, and necessarily include amounts which are based on management's best estimates and judgments.

Required

a. What are the purposes of the two parts of the report of management?

b. What is the auditor's responsibility related to the report of management?

6-25 (Objective 6-3) The following information was obtained from several accounting and auditing enforcement releases issued by the Securities and Exchange Commission (SEC) after its investigation of fraudulent financial reporting involving Just for Feet, Inc.:

> **Just for Feet, Inc.,** was a national retailer of athletic and outdoor footwear and apparel based in Birmingham, AL. The company incurred large amounts of advertising expenses and most vendors offered financial assistance through unwritten agreements with Just for Feet to help pay for these advertising expenses. If Just for Feet promoted a particular vendor's products in one of its advertisements, that vendor typically would consider agreeing to provide an "advertising co-op credit" to the Company to share the costs of the advertisement. Just for Feet offset this co-op revenue against advertising expense on its income statement, thereby increasing its net earnings. Although every vendor agreement was somewhat different, Just for Feet's receipt of advertising co-op revenue was contingent upon subsequent approval by the vendor. If the vendor approved the advertisement, it would usually issue the co-op payment to Just for Feet in the form of a credit memo offsetting expenses on Just for Feet's merchandise purchases from that vendor. During fiscal year 1998, the company's CFO, controller, and VP of Operations directed the Company's accounting department to book co-op receivables and related revenues that they knew were not owed by certain vendors, including Asics, New Balance, Nike, and Reebok. These fraudulent practices resulted in over $19 million in fictitious pretax earnings being reported, out of total pretax income of approximately $43 million. The SEC ultimately brought charges against a number of senior executives at Just for Feet and some vendor representatives.

Required

1. What does it mean to approach an audit with an attitude of professional skepticism?
2. What circumstances related to the accounting treatment of the vendor allowances should increase an auditor's professional skepticism?
3. What factors might have caused the auditor to inappropriately accept the assertions by management that the vendor allowances should be reflected in the financial statements?
4. Develop three probing questions related to the vendor allowances that the auditor should have asked in the audit of Just for Feet's financial statements.

6-26 (Objectives 6-6, 6-8) The following are specific balance-related audit objectives applied to the audit of accounts receivable (a. through h.) and management assertions about account balances (1 through 4). The list referred to in the specific balance-related audit objectives is the list of the accounts receivable from each customer at the balance sheet date.

Specific Balance-Related Audit Objective

a. There are no unrecorded receivables.
b. Receivables have not been sold or discounted.
c. Uncollectible accounts have been provided for.
d. Receivables that have become uncollectible have been written off.
e. All accounts on the list are expected to be collected within 1 year.
f. The total of the amounts on the accounts receivable listing agrees with the general ledger balance for accounts receivable.
g. All accounts on the list arose from the normal course of business and are not due from related parties.
h. Sales cutoff at year-end is proper.

Management Assertion about Account Balances

1. Existence
2. Completeness
3. Valuation and allocation
4. Rights and obligations

Required

For each specific balance-related audit objective, identify the appropriate management assertion. (*Hint:* See Table 6-4 on page 181.)

6-27 (Objective 6-6) The following are various management assertions (a. through m.) related to sales and accounts receivable.

Management Assertion

a. Recorded sales transactions have occurred.
b. There are no liens or other restrictions on accounts receivable.
c. All sales transactions have been recorded.
d. Receivables are appropriately classified as to trade and other receivables in the financial statements and are clearly described.
e. Sales transactions have been recorded in the proper period.
f. Accounts receivable are recorded at the correct amounts.
g. Sales transactions have been recorded in the appropriate accounts.
h. All required disclosures about sales and receivables have been made.
i. All accounts receivable have been recorded.
j. Disclosures related to receivables are at the correct amounts.
k. Sales transactions have been recorded at the correct amounts.
l. Recorded accounts receivable exist.
m. Disclosures related to sales and receivables relate to the entity.

Required

a. Explain the differences among management assertions about classes of transactions and events, management assertions about account balances, and management assertions about presentation and disclosure.

b. For each assertion, indicate whether it is an assertion about classes of transactions and events, an assertion about account balances, or an assertion about presentation and disclosure.

c. Indicate the name of the assertion made by management. (*Hint:* See Table 6-2 on page 175.)

6-28 (Objective 6-4) The following general ledger accounts are included in the trial balance for an audit client, Jones Wholesale Stationery Store.

Accounts payable	Depreciation expense—furniture and equipment	Prepaid insurance
Accounts receivable	Furniture and equipment	Property tax expense
Accrued interest expense	Income tax expense	Property tax payable
Accrued sales salaries	Income tax payable	Purchases
Accumulated depreciation—furniture and equipment	Insurance expense	Rent expense
Advertising expense	Interest expense	Retained earnings
Allowance for doubtful accounts	Inventory	Salaries, office and general
Bad debt expense	Loans payable	Sales
Cash	Notes payable	Sales salaries expense
Common stock	Notes receivable—trade	Telecommunications expense

Required

a. Identify the accounts in the trial balance that are likely to be included in each transaction cycle. Some accounts will be included in more than one cycle. Use the format that follows.

Cycle	Balance Sheet Accounts	Income Statement Accounts
Sales and collection		
Acquisition and payment		
Payroll and personnel		
Inventory and warehousing		
Capital acquisition and repayment		

b. How will the general ledger accounts in the trial balance most likely differ if the company were a retail store rather than a wholesale company? How will they differ for a hospital or a government unit?

6-29 (Objective 6-8) The following are two specific balance-related audit objectives in the audit of accounts payable. The list referred to is the list of accounts payable taken from the accounts payable master file. The total of the list equals the accounts payable balance on the general ledger.

1. All accounts payable included on the list represent amounts due to valid vendors.
2. There are no unrecorded accounts payable.

Required

a. Explain the difference between these two specific balance-related audit objectives.
b. Which of these two specific balance-related audit objectives applies to the general balance-related audit objective of existence, and which one applies to completeness?
c. For the audit of accounts payable, which of these two specific balance-related audit objectives is usually more important? Explain.

6-30 (Objective 6-8) The following (1 through 18) are the balance-related, transaction-related, and presentation and disclosure-related audit objectives.

Balance-Related Audit Objectives

1. Existence
2. Completeness
3. Accuracy
4. Classification
5. Cutoff
6. Detail tie-in
7. Realizable value
8. Rights and obligations

Transaction-Related Audit Objectives

9. Occurrence
10. Completeness
11. Accuracy
12. Classification
13. Timing
14. Posting and summarization

Presentation and Disclosure Audit Objectives

15. Occurrence and rights
16. Completeness
17. Accuracy and valuation
18. Classification and understandability

Required

Identify the specific audit objective (1 through 18) that each of the following specific audit procedures (a. through l.) satisfies in the audit of sales, accounts receivable, and cash receipts for fiscal year ended December 31, 2013.

a. Examine a sample of duplicate sales invoices to determine whether each one has a shipping document attached.
b. Add all customer balances in the accounts receivable trial balance and agree the amount to the general ledger.
c. For a sample of sales transactions selected from the sales journal, verify that the amount of the transaction has been recorded in the correct customer account in the accounts receivable subledger.
d. Inquire of the client whether any accounts receivable balances have been pledged as collateral on long-term debt and determine whether all required information is included in the footnote description for long-term debt.
e. For a sample of shipping documents selected from shipping records, trace each shipping document to a transaction recorded in the sales journal.
f. Discuss with credit department personnel the likelihood of collection of all accounts as of December 31, 2013, with a balance greater than $100,000 and greater than 90 days old as of year end.
g. Examine sales invoices for the last five sales transactions recorded in the sales journal in 2013 and examine shipping documents to determine they are recorded in the correct period.
h. For a sample of customer accounts receivable balances at December 31, 2013, examine subsequent cash receipts in January 2014 to determine whether the customer paid the balance due.
i. Determine whether all risks related to accounts receivable are adequately disclosed.
j. Foot the sales journal for the month of July and trace postings to the general ledger.
k. Send letters to a sample of accounts receivable customers to verify whether they have an outstanding balance at December 31, 2013.
l. Determine whether long-term receivables and related party receivables are reported separately in the financial statements.

6-31 (Objectives 6-6, 6-7) The following are specific transaction-related audit objectives applied to the audit of cash disbursement transactions (a. through f.), management assertions about classes of transactions (1 through 5), and general transaction-related audit objectives (6 through 11).

Specific Transaction-Related Audit Objective

a. Recorded cash disbursement transactions are for the amount of goods or services received and are correctly recorded.
b. Cash disbursement transactions are properly included in the accounts payable master file and are correctly summarized.
c. Recorded cash disbursements are for goods and services actually received.
d. Cash disbursement transactions are properly classified.
e. Existing cash disbursement transactions are recorded.
f. Cash disbursement transactions are recorded on the correct dates.

Management Assertion about Classes of Transactions	General Transaction-Related Audit Objective
1. Occurrence	6. Occurrence
2. Completeness	7. Completeness
3. Accuracy	8. Accuracy
4. Classification	9. Posting and summarization
5. Cutoff	10. Classification
	11. Timing

Required

a. Explain the differences among management assertions about classes of transactions and events, general transaction-related audit objectives, and specific transaction-related audit objectives and their relationships to each other.
b. For each specific transaction-related audit objective, identify the appropriate management assertion.
c. For each specific transaction-related audit objective, identify the appropriate general transaction-related audit objective.

6-32 (Objective 6-10) Following are seven audit activities.

a. Examine invoices supporting recorded fixed asset additions.
b. Review industry databases to assess the risk of material misstatement in the financial statements.
c. Summarize misstatements identified during testing to assess whether the overall financial statements are fairly stated.
d. Test computerized controls over credit approval for sales transactions.
e. Send letters to customers confirming outstanding accounts receivable balances.
f. Perform analytical procedures comparing the client with similar companies in the industry to gain an understanding of the client's business and strategies.
g. Compare information on purchases invoices recorded in the acquisitions journal with information on receiving reports.

Required

For each activity listed above, indicate in which phase of the audit the procedure was likely performed.

1. Plan and design an audit approach based on risk assessment procedures (Phase I)
2. Perform tests of controls and substantive tests of transactions (Phase II)
3. Perform analytical procedures and tests of details of balances (Phase III)
4. Complete the audit and issue an audit report (Phase IV)

RESEARCH PROBLEM 6-1: INTERNATIONAL AND PCAOB AUDIT OBJECTIVES

This problem requires you to access authoritative standards to compare the objective of an audit as defined by AICPA auditing standards (see p. 162) and International Standards on Auditing (ISA 200) (www.iaasb.org) and the objective of an audit of internal control over financial reporting as defined by PCAOB auditing standards (AS 5) (www.pcaobus.org).

Required

a. Compare the objective of an audit under AICPA Auditing Standards and International Standards on Auditing. Are there substantive differences in the objective of an audit as defined by these two standards?
b. What is the objective of an audit of internal control over financial reporting according to PCAOB auditing standards?
c. What defines whether financial statements are fairly stated, and what defines whether internal control is considered effective? Are they related?

2013 Annual Report



CONTENTS

Rick Chulick, President and Chief Operating Officer

DEAR SHAREHOLDERS

March 29, 2014

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 2012 to 2013. 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.

Christopher J. Kurran
Chief Executive Officer

Rick Chulick
President and Chief Operating Officer




History

Hillsburg Stores Inc. began operations in 1984 in Gary, Indiana, as a retail hardware store chain. On September 25, 1990, 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, 1994, after spinning off all of its lumber-related assets to Handy Corporation, the company changed its name to Hillsburg Hardware, Inc. On October 22, 1996, 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.

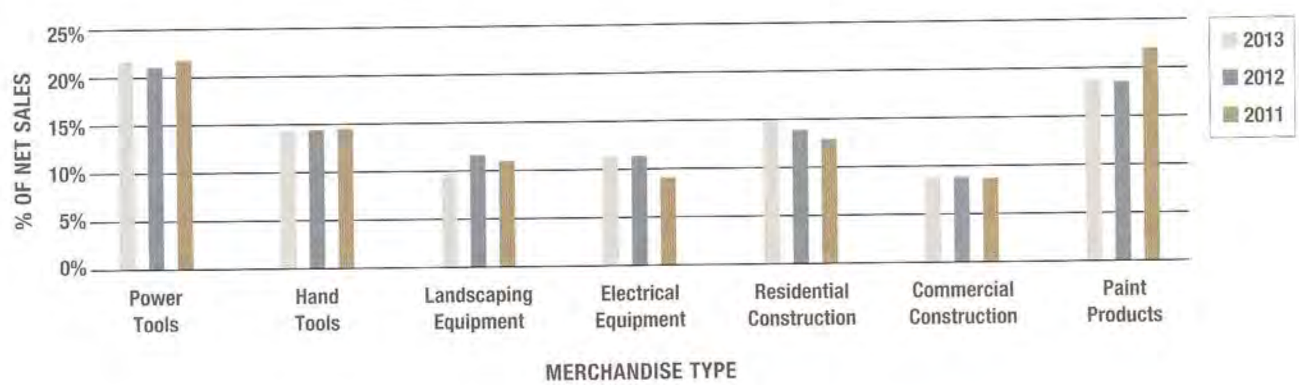
To further encourage customer loyalty, each customer is given access to our internal database system—ONHAND (Online Niche-Hardware Availability Notification Database). The ONHAND system lets customers check the availability of hard-to-find products instantly over the Internet. Moreover, the system includes 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 2013, 2012, and 2011:



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.

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 2013 increase in sales of 9%.

Customers

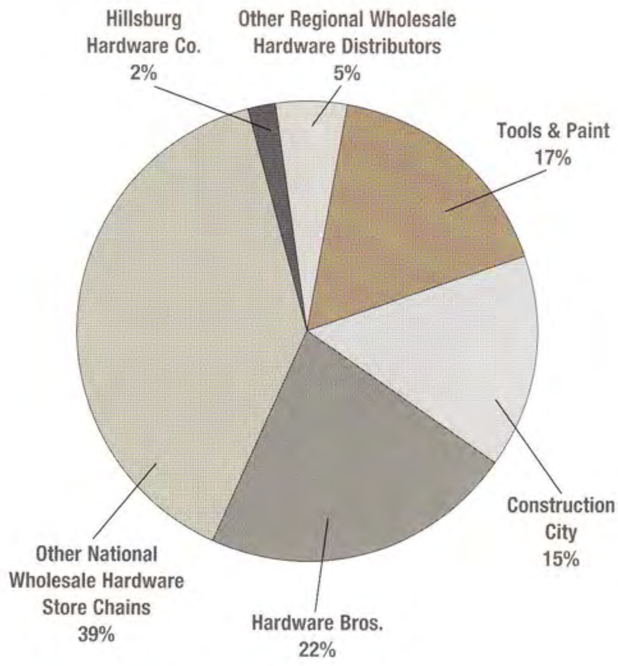
The majority of our customers are located in Illinois, Michigan, Wisconsin, Ohio, and Missouri. Our current customer base consists of more than 400 independently owned hardware stores. Approximately 25% of our customers make up more than 80% of total sales revenue. To promote long-standing relationships with customers, we offer an array of incentive and customer appreciation programs. Since these programs were implemented in 2004, 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 2013, 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 2014. The combined dollar amount of each contract is not expected to exceed 5% of total purchases for the year.

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.



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.

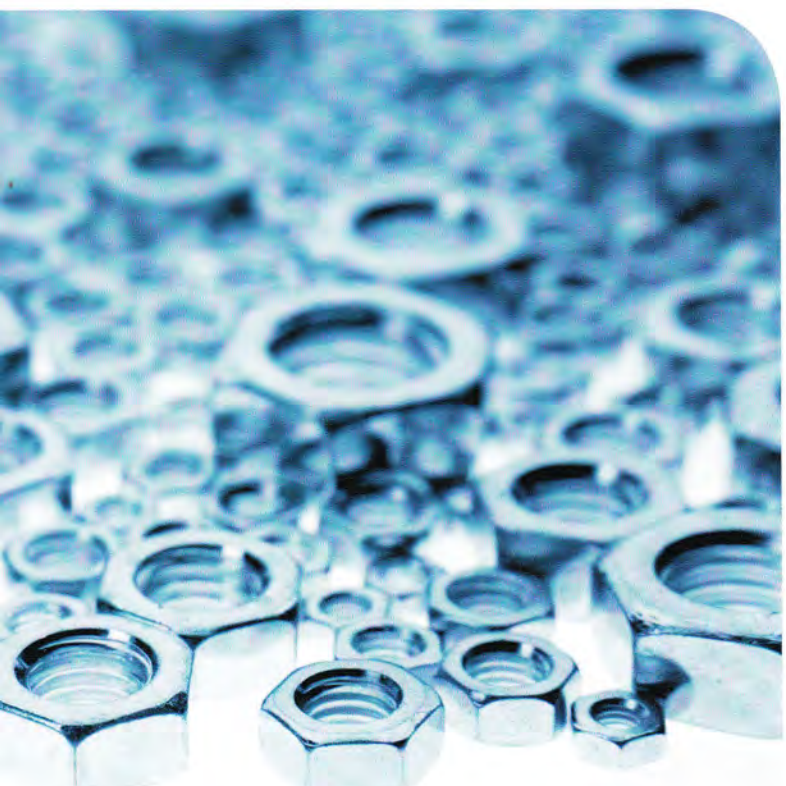
Legal Proceedings

On September 3, 2012, 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:



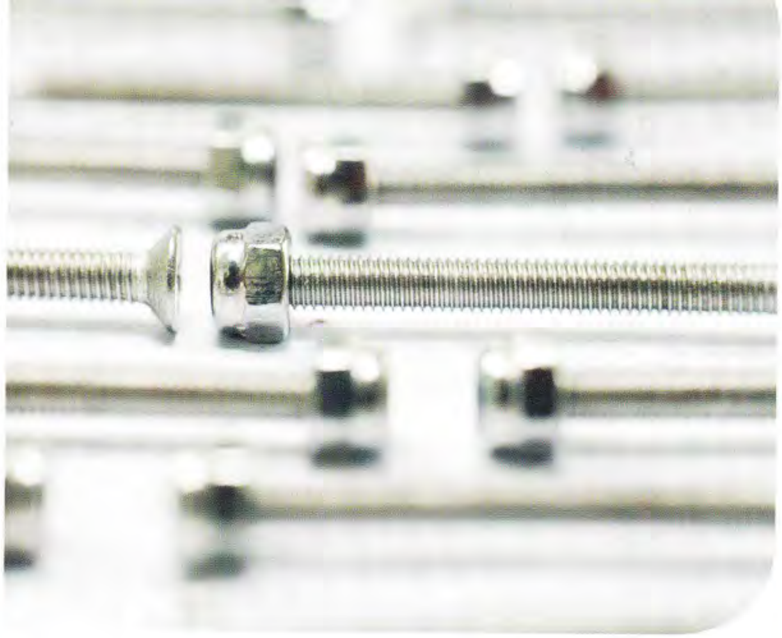
	NAME	AGE	POSITION
	John P. Higgins	55	Chairman of the Board
	Christopher J. Kurran	47	Chief Executive Officer (b)
	Rick Chulick	48	President and Chief Operating Officer (a)
	Avis A. Zomer	44	Chief Financial Officer
	Brandon S. Mack	51	Vice President Sales and Marketing
	Mary R. Moses	36	Vice President 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 for ten years, since November 2003. Mr. Chulick was Chairman of the Board from 2006 to 2008.

(b) Mr. Kurran has been Chief Executive Officer of the Company since September 2003. Prior to his role as CEO, Mr. Kurran was employed from 1994-2002 by Trini Enterprises, an industrial distributor.

(c) Ms. Namie has been employed by the company since its inception in 1996. She has held her current position since 2002 and served as an operations manager from 1996-2002.

(d) Mr. Akins was Chief Operating Officer and President of Hardware Bros., one of the ten largest wholesale hardware chains in the nation, from 2000-2005.



"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 over the internal verification and timely recording of sales transactions. 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, 2013 based on criteria established in the COSO *Internal Control-Integrated Framework.*

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 2013 and 2012:

	2013		2012	
	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, 2014, 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 2013, 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

We have audited the accompanying balance sheets of Hillsburg Hardware Company as of December 31, 2013 and 2012, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2013. We have also audited Hillsburg Hardware Company, Inc.'s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Hillsburg Hardware 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 these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. 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.

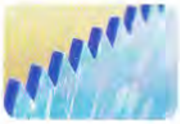
A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hillsburg Hardware Company, Inc. as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Hillsburg Hardware Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Berger & Anthony, LLP

Berger and Anthony, LLP
Gary, Indiana
March 21, 2014




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, 2013. 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*. Based on our assessment we believe that, as of December 31, 2013, 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 page.

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	
ASSETS	**2013**	**2012**
Current assets		
Cash and cash equivalents	$ 828	$ 743
Trade receivables (net of allowances of $1,240 and $1,311)	18,957	16,210
Other receivables	945	915
Merchandise inventory	29,865	31,600
Prepaid expenses	432	427
Total current assets	51,027	49,895
Property and equipment		
Land	3,456	3,456
Buildings	32,500	32,000
Equipment, furniture, and fixtures	6,304	8,660
Less: accumulated depreciation	(31,920)	(33,220)
Total property and equipment (net)	10,340	10,896
Total assets	**$ 61,367**	**$ 60,791**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
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
Long-term notes payable	24,120	26,520
Deferred income taxes	738	722
Other long-term payables	830	770
STOCKHOLDERS' EQUITY		
Capital stock ($1 par value; 5,000,000 shares issued)	5,000	5,000
Capital in excess of par value	3,500	3,500
Retained earnings	13,963	11,929
Total stockholders' equity:	**22,463**	**20,429**
Total liabilities and stockholders' equity	**$ 61,367**	**$ 60,791**

See Notes to Financial Statements.

Hillsburg Hardware Company
Statement of Operations (in thousands)

	Year Ended December 31		
	2013	**2012**	**2011**
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		Paid-in	Retained	Total
	Shares	**Par value**	**Capital**	**Earnings**	**Stockholders' Equity**
Balance as of December 31, 2010	**5,000**	**$ 5,000**	**$ 3,500**	**$ 10,256**	**$ 18,756**
Net income				2,279	2,279
Dividends paid				(1,900)	(1,900)
Balance as of December 31, 2011	**5,000**	**$ 5,000**	**$ 3,500**	**$ 10,635**	**$ 19,135**
Net income				3,194	3,194
Dividends paid				(1,900)	(1,900)
Balance as of December 31, 2012	**5,000**	**$ 5,000**	**$ 3,500**	**$ 11,929**	**$ 20,429**
Net income				3,934	3,934
Dividends paid				(1,900)	(1,900)
Balance as of December 31, 2013	**5,000**	**$ 5,000**	**$ 3,500**	**$ 13,963**	**$ 22,463**

See Notes to Financial Statements.

Hillsburg Hardware Company
Statement of Cash Flows (in thousands)

	Year Ended December 31		
OPERATING ACTIVITIES	**2013**	**2012**	**2011**
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
INVESTING ACTIVITIES			
Capital expenditures	(10,500)	(1,800)	(2,292)
Sale of equipment	10,324	–	–
Net cash used in investing activities	(176)	(1,800)	(2,292)
FINANCING ACTIVITIES			
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)
Net increase in cash and cash equivalents	85	23	65
Cash and cash equivalents at beginning of year	743	720	655
Cash and cash equivalents at end of year	$ 828	$ 743	$ 720

See Notes to Financial Statements.




1. Description of Significant Accounting Policies and Business

We are 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 our customers are smaller, independent hardware stores located in Illinois, Michigan, Wisconsin, Ohio, and Missouri.

Allowance for Doubtful Accounts: Our 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, we adjust inventory balances 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, 2013, 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 2014 and the other two mature on December 31, 2016. During 2013, there was an additional note outstanding in the amount of $4,400,000, which was paid off during October 2013.

4. Commitments

The Company is currently committed to an operating lease that expires in 2017. Rental payments for the remainder of the contract are set at $312,000 per annum.

5. 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

	2013	2012	2011
Power Tools	$ 31,479	$ 27,557	$ 26,991
Hand Tools	21,463	19,684	18,403
Landscaping Equipment	14,309	15,645	13,494
Electrical Goods	17,170	15,849	11,042
Residential Construction Equipment	21,463	18,372	15,949
Commercial Construction Equipment	11,447	10,498	9,815
Paint Products	25,755	23,621	26,991
	$143,086	**$131,226**	**$122,685**

6. Earnings Per Share

Earnings per share calculations for 2013, 2012, and 2011 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, 2013, gross profit increased by 9.6% or $3,495,000 from 2012. This increase in gross profit more than offsets the increase in operating expenses from 2012 to 2013 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, 2012, gross profit increased by $2,389,000 or 7% from 2011. Total operating expenses increased by $1,219,000 or approximately 4.3% from 2011. 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 2012 to 2013 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 2013. Net sales for 2012 increased by $8,541,000 or 7.0% from 2011, which is consistent with industrywide average revenue growth of 7% from 2011 to 2012.

Gross Profit: Gross profit as a percentage of net sales stayed relatively stable at 27.68% and 27.70% in 2011 and 2012, respectively, but increased to 27.85% in 2013. The 2013 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 2012 to 2013 and by $805,000 or 6.7% from 2011 to 2012. As a percentage of net sales, selling expenses increased by 0.52% since 2012 and decreased by 0.03% from 2011 to 2012. The increase in selling expenses as a percentage of net sales from 2012 to 2013 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 2012 to 2013 and by $414,000 or 2.5% from 2011 to 2012. As a percentage of net sales, general and administrative expenses decreased by 0.42% since 2012 and decreased by 0.55% from 2011 to 2012. The overall increase from 2012 to 2013 was caused mostly by unexpected repairs needed to reattach and replace damaged shelving units in our main warehouse building.

Interest Expense: In 2013, interest expense increased by $374,000, or approximately 18.4%, compared to 2012. 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 2012 interest expense decreased by $138,000 or 6.4% compared to 2011. The 2012 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 2013 were approximately 10.5% and 8.5% respectively.

Liquidity

During 2013, 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 2013 was approximately 10.5%

Cash provided by operating activities for 2013 and 2012 was $4,910,000 and $4,146,000 respectively. The change from 2012 to 2013 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 2011 to 2012 is largely the result of the increase in net income and smaller increases in receivables and merchandise inventory in 2012 compared to 2011. 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 2013 and 2012. Merchandise inventory turned over approximately 3.4 times in 2013 and 3.0 times in 2012. Average days to sell inventory were 108.6 and 120.9 in 2013 and 2012 respectively. Net trade receivables turned over approximately 7.6 times in 2013 and in 2012. Days to collect accounts receivable computations were 48.1 and 48.0 in 2013 and 2012 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 2013 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 2014, we will continue to apply the same strategic efforts that improved 2013 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)

BALANCE SHEET DATA:	**2013**	**2012**	**2011**	**2010**	**2009**
Current assets	$ 51,027	$ 49,895	$ 49,157	$ 47,689	$ 46,504
Total assets	61,367	60,791	59,696	57,441	51,580
Current liabilities	13,216	12,350	12,173	12,166	9,628
Long-term notes payable	24,120	26,520	26,938	25,432	25,223
Total stockholders' equity	22,463	20,429	19,135	18,756	15,764
INCOME STATEMENT DATA:					
Net sales	$ 143,086	$ 131,226	$ 122,685	$ 120,221	$ 117,115
Cost of sales	103,241	94,876	88,724	88,112	85,663
Gross profit	39,845	36,350	33,961	32,109	31,452
Earnings before income taxes	5,681	4,659	3,351	3,124	1,450
Net income	3,934	3,194	2,279	2,142	994
Cash provided by operating activities	4,910	4,146	2,655	1,811	1,232
Per common share data:					
Net income	$ 0.79	$ 0.64	$ 0.46	$ 0.43	$ 0.22
Cash dividends per share	$ 0.38	$ 0.38	$ 0.38	$ —	$ —
Common shares outstanding	5,000	5,000	5,000	5,000	4,500
KEY OPERATING RESULTS AND FINANCIAL POSITION RATIOS:					
Gross profit (%)	27.85%	27.70%	27.68%	26.71%	26.86%
Return on assets (%)	9.30%	7.73%	5.72%	5.73%	2.86%
Return on common equity (%)	26.49%	23.55%	17.69%	18.10%	9.50%