HERSHEY

Group 2 - PPE

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INTRODUCTION

One of the largest chocolate manufacturing companies in the world, The Hershey Company (commonly known as Hershey) has a global presence and a strong foothold in the confectionary market. Started by Milton Hershey in the late 1800s, Hershey made its name through leveraging new technology to make affordable chocolate ("Milton S. Hershey," n.d.). While previously chocolate had been an expensive delicacy for the rich, German chocolate-making machinery and an original milk chocolate recipe enabled Hershey to mass produce a cheap treat available to anyone.

We chose Hershey due to its remarkable success and its focus on corporate responsibility. Cementing itself as one of the top chocolate makers globally, Hershey has been incredibly successful over the past century with billions in revenue. Consistently high-performing, Hershey translates this success to stockholders through steadily increasing stockholder dividends for decades ("The Hershey Company: Dividend Stock Analysis," 2018). With a long history of success and growth, Hershey presents itself as an interesting and unique company to analyze. Along with its financial success, Hershey publishes a corporate social responsibility report with goals aligned with the United Nations Sustainable Development Goals, with objectives including the protection of biodiversity and support of education ("This is Shared Goodness," 2017). As auditors, we have a responsibility to the public to ensure Hershey fairly presents its financial statements so that its users can depend on the information; as we analyze the firm's reliability, this responsibility also ties into Hershey's corporate social responsibility promises.

CHAPTER 1: Client Acceptance Process

Before an audit begins, it is important to set guidelines with the potential client (Louwers, Ramsay, Sinason, Strawser, & Thibodeau, 2015). We must ask ourselves if is there any risk in auditing Hershey. In the process of onboarding Hershey as a client, it is vital that we evaluate the company as a whole to determine if they will be cooperative. To begin this, we must to get to know the client through the news and client reports, exercising professional skepticism. We must also attempt to contact Hershey's predecessor auditor, if Hershey allows us (Louwers et al., 2015). A predecessor auditor could help to confirm any information which we find concerning. If Hershey declines us meeting with their predecessor auditor, we have to assume that there is information Hershey does not want us to know about. In this case, nothing discussed alarmed us and we were able to get a better understanding of Hershey has our potential client. Because Hershey decided to change their auditor, it is required that they file a *Form 8-K* to update the SEC and have it be approved by the Board of Directors. This was approved and we were able to accept Hershey as our client.

CHAPTER 2: Entity's Environment

To obtain an understanding of Hershey, we first looked at its external environment. Hershey operates in the food industry and specializes in confectionary, operating primarily in North America. The confectionary industry has an intense level of competition, as 70% of sales come from the top four manufacturers, which include Hershey (Watrous, 2017). Overall, the confectionary industry has been growing, but companies have to adjust to consumer attitudes in order maintain their position in the marketplace. For regulations, a report by the National Confectioners Association explains that the major goal of all food regulations in the confectionary industry arises from two items: safety and wholesomeness, so we must be generally aware of Hershey's controls to prevent contamination (Bodor, 2008). Based on these facts, the first main risk from the external environment is the high level of competition. Hershey has several major competitors, particularly Nestle and Mars, that have similar products and hold most of the market share (Watrous, 2017). On top of this concern, Hershey occupies the "mature" stage of the business cycle, and so must keep a close eye on emerging markets and possible investments to prevent its decline.

Moving to its internal organization, Hershey has an unusual corporate structure, as a trust holds most of its shares. In terms of overall structure, Hershey is fairly centralized, with about 16.9 thousand employees in 2017 ("Hershey Co," n.d.). Most of its operations are located in the northern United States, with 6 plants in North America (The Hershey Company, 2018). A management team composed of seven executives runs the company, overseen by the Board of Directors. Hershey's financing primarily comes from long-term debt, primarily used to decrease the cost of capital. Its controlling stockholder is the Hershey Trust Company, which maintains voting control as it holds the majority of the shares. According to its 10K, Hershey principally invests in PP&E, software, and business acquisition. Its profits mainly rest in its core brands of chocolate: *Reeses, Kisses, Kit Kats,* and *Hershey*'*s*.

Taking a look at Hershey's strategy and future objectives, Hershey appears to be focusing on mergers and acquisition, planning to specialize in snacks along with chocolate. Hershey just purchased Amplify which is the parent company of SkinnyPop (Hirsch, 2017). This can be seen as a business risk because Hershey does not have the necessary expertise to tackle the snacking industry, and is also an area of concern due to the fact that many of their newly introduced products have resulted in failure. Customers disregard all their new products and only focus on what they have been known to be good at: chocolate.

Despite these concerns, Hershey still has been doing well financially; both its net income and earnings per share have increased since last year, with earnings per share standing out at an 8.5% increase ("Hershey reports first-quarter results," 2018). Along with these changes, Hershey's gross margin also increased to 49.4% in 2018, and it raised dividends by 10% which continues an 8 year streak of consecutive dividend increases (Global Newswire, 2018). According to the Motley Fool, the successful integration of Amplify drives part of these strong numbers, indicating that Hershey's strategy of mergers and acquisitions, although bumpy, has started to work (Bowman, 2018). This also indicates that Hershey has very high investor risk; between consistent dividend payments for the past 8 years and the Hershey Trust Company, Hershey faces heavy pressure to perform well for its shareholders.

When examining internal controls, we need to keep in mind the three requirements for internal control: reliable financial reporting, compliance with laws, and efficient and effective operations (Louwers et al., 2015). We will consider these requirements through analyzing 5 components: the control environment, risk assessment, control activities, monitoring, and information/communication. For the first component, we need to take a look at Hershey's value to determine the tone set by management. Hershey defines itself as a company with a passion for goodness, so we will need to conduct inquiries of employees throughout the company to see if this is the reality. We will also assess management like the Board of Directors to determine if the company set the proper tone for an effective control environment. Next, we will review Hershey's framework for risk assessment, Enterprise Risk management (The Hershey Company, 2018). We expect to see Hershey's objectives as focused around its shareholders and social work, based on our previous analysis. We will then examine Hershey's control activities through testing their controls to see if the controls have been effectively designed to lower risk of material misstatement. We will work with Hershey's internal auditors to determine the effectiveness of the company's monitoring of internal controls and determine if Hershey's boards and management conduct assessments and review controls. Finally, we will take into account Hershey's information structure, along with its charters with its suppliers and systems.

CHAPTER 3: Preliminary Engagement Activities

As part of our preliminary engagement activities, we must check compliance with independence and ethical requirements and send an engagement letter to the client (Louwers et al, 2015). Ethical requirements require exercising independence and due care; we must be independent in fact and in appearance. No partner or staff of our engagement team has any vested interest in Hershey whatsoever. Beyond this basic review, we also researched our team's connection to the confectionary industry in general; each member was independent in fact and appearance. To establish a mutual understanding with our client, we will document the engagement's requirements and expectations in an engagement letter, establishing our responsibilities as auditors and Hershey's responsibilities as the client. We will audit the financial statements of Hershey and its internal control based on the COSO framework; Hershey must prepare the financial statements while maintaining and assessing their internal controls. We also noted the limitations of the engagement; since Hershey is a global company with billions in sales, we will provide reasonable assurance that their financial statements are free of material misstatement.

CHAPTER 4: Assess Risks and Establish Materiality

To assess the risks, we will conduct preliminary procedures through establishing an expectation for the PP&E account balance. Based on Hershey's budgets, forecasts, and previous financial statements, we expect the PP&E account balance to be between $2.1 billion and $2.12 billion. For the past several years, Hershey's PP&E account balance has remained around $2.1

billion mark, and Hershey's budgets indicate it expects this trend to continue (The Hershey Company, 2018). Forecasts further support this, as Hershey is still growing its business. For the year 2018, Hershey has started a $60M expansion of one of its plants, but as they have only started construction this year, we do not expect to see a significant impact on the PP&E account balance (Knight, 2018).

We established the materiality threshold of 5-8% of profit before taxes, based on the industry benchmark of 5% (Financial Reporting Council, 2017). Anything over 8% will be considered material, anything under 5% will be considered immaterial, and anything in between will require closer examination and professional judgement. These thresholds were established because of the nature of PP&E is highly illiquid, and so is less risky than other accounts. Hershey's performance as a company has also been strong and stable for decades, further decreasing the risk. For these reasons, we determined that we could raise the materiality benchmark from 5%. However, we set the 5-8% range due to 2 significant circumstances: (1) Hershey is a global company that owns plants and properties across the world, and (2) Hershey faces high pressure from investors to continue its consistent dividend increase. As Hershey's main form of investment, PP&E should be examined closely to ensure that Hershey does not manipulate aspects like valuation to improve its financial performance. At the end of the audit, we will also take into consideration the cumulative effects of misstatements.

Examining the inherent risk of PP&E, we determined a 75% risk of susceptibility to misstatement, based on 4 factors: dollar size, liquidity, volume of transactions, and complexity of transactions. Although Hershey's PP&E account is highly illiquid with a low volume of transactions, it has a large dollar size of transactions and large account balance. Most significantly, PP&E transactions can be incredibly complex, due to tricky capitalization calculations and depreciation. Hershey hires competent accountants to decrease the risk of misstatement, but the risk level still remains high. As inherent risk represents the level of risk outside of internal controls, the likelihood of a misstatement happening under these circumstances is high.

We determined control risk to be at 60% based on Hershey's control systems, as it is our first year auditing Hershey. Overall, though, Hershey's finance department is composed of experienced CPAs, which helps prevent errors. Their work is subject to several levels of review and Hershey requires periodic trainings to ensure quality work. In the case of particularly tricky transactions, such as the valuation of a property in a foreign country, Hershey hires outside experts to assist its accounting team. Hershey also has a highly objective and competent internal audit team, who work under the audit committee and test internal controls throughout the year. Our own review of the internal controls, detailed later, also led us to conclude that Hershey has a strong internal control system which effectively lowers the risk of material misstatement.

We set overall audit risk, the risk of issuing an unqualified opinion when the financial statements have material misstatements, to be 5%. As laid down by our firm policy, audit risk should not be higher than 5%. Solving for detection risk, the risk that we will fail to detect a misstatement is 11%, meaning that we must expand substantive procedures. Beyond this risk model, we also have to take the risk of fraud into account. Hershey has undergone some significant scandals; in 2012, a law firm claimed that Hershey's Board actively incorporated child labor into its business model (Bloxham, 2012). The scandals faced by the food industry impact the control environment, as the board of director helps set the tone at the top, which significantly impact fraud risk. Fraud risk also stems from the acquisition and disposal of property. Capitalization has proven itself to be highly susceptible to fraud, as shown in previous scandals. In the famous case of Worldcom, accountants used capitalization to inflate its profits, changing its net loss to a billion dollar profit. In another important fraud case concerning PP&E, Waste Management falsified its financial statements through depreciation, improving its results through inflating salvage values and increasing useful lives. Based on the precedent set by these cases, we will have to carefully examine Hershey's depreciation and capitalization due to fraud risk.

CHAPTER 5: Consider Internal Control

Based on the relevant assertions for PP&E, we have identified some of Hershey's internal controls relevant to this audit. For PP&E, auditors must ensure that the equipment and other items actually exist. Hershey has periodic evaluation of its plant locations, ensuring that their plants still exist and reviewing their condition. They also provide security measures to protect property and equipment from theft, including restricted key card access to equipment and plants, security cameras at its plants, and physical measures like electric fences. Due to Hershey having locations worldwide, we are not able to review all plant locations; instead, our sample consists of three properties, as discussed below. The next relevant assertion, rights and obligation, claims that Hershey actually owns the property it claims to own. For this assertion, Hershey uses purchase authorization, requiring executive approval for the purchase of new property and the building of new plants. We will review Hershey's documentation and conduct inquiries of executives to examine this assertion. Next, we will verify completeness, determining if Hershey included all the items on its books that it should have. For this assertion, Hershey has a process of periodic reconciliation as its internal control, reconciling the balances reported on its financial statements to the actual physical assets.

Lastly, one of the most important assertions for the PP&E, valuation and allocation has a variety of internal controls put in place by Hershey. As mentioned earlier, Hershey employs experienced CPAs, holds periodic trainings, and hires outside experts when necessary. Hershey also has documented its policies on capitalization, so that its accounting treatment is consistent. As auditors, we also can use the capitalization document to determine if the accounting treatment followed the procedure correctly and valued PP&E appropriately. Additionally, Hershey also keeps a separate ledger for each major asset in PP&E, which makes allocation, and so valuation, clearer. Management approval must be obtained to adjust the ledgers, preventing manipulation and providing a level of review for capitalization that further decreases the risk of misstatement. Hershey also conducts a periodic evaluation of plant assets to check their condition and make sure they still are being valued appropriately.

Hershey also has established a proper control environment in which they have a strong focus on integrity and their ethical values. As previously discussed, Hershey participates in a set of procedures, such as document trailing and periodic trainings of CPAs, to ensure that the internal controls are properly being implemented. Two activities, known as information and communication and monitory, are integrated within the COSO framework and are considered when evaluating a firm's internal controls. Hershey also sends documents through different departments within the company to verify its obligation as well as to verify completeness. Monitoring is used to continually observe and evaluate how a firm's internal controls are being executed. As it was mentioned earlier, Hershey has participated in a variety of activities, such as hiring experienced CPAs and hiring outside experts, to help with the process of monitoring their financial documentation.

The internal controls of a company are imperative in making sure that material misstatements are detected using the controls put into place by the firm. We assessed that Hershey has a 60% control risk which means there is a moderate chance that an error or fraud will not be detected. This was established because Hershey diligently hires experienced CPAs on the job for internal auditing and also considers using experts outside of their CPAs to help with developing a proper set of internal controls. We also want to note that Hershey has applied a system where decisions that are executed relating to the financials of the firm are sent through multi-layers for review. This ensures that material misstatement does not make it past the entire chain of reviewers set in place.

While it is critical that Hershey's employees are following all the proper procedures in establishing an effective set of internal controls, management is responsible in overlooking personnel to regulate the processes that are enacted (Louwers et al., 2015). They utilize the COSO framework which examines several areas within the controls to assure that reasonable assurance will be provided by their firm's internal controls. Though management has a responsibility in regulating these internal controls, auditors are still required in testing and reviewing the internal controls so that they can make ascertain that these controls provide reasonable assurance for Hershey's financials. After the internal controls have been tested, auditors then provide an opinion regarding whether or not there is reasonable assurance. When internal controls are assessed, they must consider if Hershey has implemented their control activities to address the risk of fraud such as capitalization.

CHAPTER 6: Plan the Audit

In planning the audit, we assessed the need for specialists and determined that we would use our firm's manufacturing specialist for valuation and capitalization. We as auditors can use

Hershey's policy on capitalization to verify that Hershey's accountants followed procedures correctly, but we require the expertise of the specialist to ensure that the procedures were correct in the first place. Additionally, we assessed the possibility of illegal acts. PP&E faces risks of theft and misrepresentation of its true value. Hershey has security measures for theft of equipment, which we will test in the course of the audit, and the specialists mentioned above will assist in making sure that Hershey doesn't cross the line in its representation of the value of PP&E. We also identified any related parties, finding the Hershey Trust company to be a significant related party as one of the main owners of Hershey. As part of our audit, we will examine transactions between the Trust Company and Hershey, looking through items like minutes of board meetings for red flags.

As auditors, we are required to complete a set of preliminary analytical procedures for this engagement (Louwers et al., 2015). We will be developing expectations about what the PP&E account for Hershey should be and then we will compare it to the recorded balance provided. As mentioned earlier, we excepted Hershey's budget to be around the $2.1 billion to $2.12 billion range. We developed this expectation by basing it on the balances from comparable periods to Hershey's performance this year. We took a portion of Hershey's previous financial statements and made note of any variations in the PP&E accounts. If there is any significant difference, it needs to be within 5% of the values of the previous years or else it will be considered material.

We have put together our audit memorandum in terms of the scope, timing, and direction for auditing each relevant assertion based on the results of our audit risk model. We have set out a scope to include a sample of three plants which we will primarily set our focus on. However, Hershey has eight significant properties in North America so our sample will only consist of less than half of those properties; two of those properties will be manufacturing plants, the other will be a distribution plant. These three properties are located in Hershey, Pennsylvania, Stuarts, Virginia, and Edwardsville, Illinois (The Hershey Company, 2018). Our audit will include extensive supervision and review throughout each step to ensure that we perform a high quality audit. Since the risk that we will not detect a material misstatement is 11%, we will be taking extra safety precautions to make sure we detect any irregularities in the financials of Hershey.

As part of our audit for Hershey, we will audit the plant, property, and equipment account. Our first step will be reconciling subsidiary records to the general ledger in order to test completeness. For Hershey, we would take the separate ledger for each plant and property, then reconcile them to its general ledger. Next, we will select a sample assets to observe and inspect. As mentioned earlier, our sample consists of 3 of Hershey's plants out of its 8 significant properties in North America: 2 manufacturing, one distribution. We will conduct site visits to these plants to physically observe them, testing the assertion of existence and gathering tentative evidence on valuation. Hershey has been around since the late 1800s, which means parts of PP&E can be very old, so we must verify the state of PP&E. We will also perform inspections of the sample, examining title documents to test rights and obligations to ensure that the Hershey actually owns the properties it claims.

Once we have verified the existence of the assets and the rights and obligations, we will move towards examining Hershey's acquisitions and disposals. We consider this particularly important as Hershey uses PP&E as one of its main investment strategies (The Hershey Company, 2018). As part of its processes, Hershey prepares a schedule of acquisition and disposals. During this past year, Hershey started a $60 million expansion of one of its properties; it also received $7.6 million in proceeds from sales of PP&E (The Hershey Company, 2018). In our review of this schedule, we will use vouching and tracing to test the existence and completeness assertions. First, we will review Hershey's purchase authorization process, vouching documents to check for proper approval. Next, we will vouch the costs of PP&E to relevant documents including receipts and contracts. We will confirm contracts with the outsider parties for Hershey's purchase and sale for PP&E; for the $7.6 million PP&E sold, we will inspect the documents supporting the sale, confirming with the outside parties. We will also vouch cash receipts for the proceeds of the sale to test occurrence and accuracy. Along with vouching, we will trace these amounts to the subsidiary ledgers up to the general ledger to test completeness of PP&E, expecting to see the addition and the sales of property. Additionally, for the $60 million expansion, we will review its associated contracts to further verify its existence. Next, we will recalculate Hershey's impairments for its property. As some of its property has been around for decades, Hershey sometimes has to recognize impairment losses; in 2017, it had a $102.7 million write-down for PP&E. We will recalculate those charges to test their accuracy.

One major focus of our audit will be the capitalization of PP&E. As a high-risk area, we will use additional substantive procedures to keep our overall audit risk low. Hershey has a capitalization policy for its accountants to follow, which details the processes for capitalization to keep Hershey's treatment consistent. We first plan to conduct interviews with Hershey's accounting staff to gain a better understanding its capitalization policy through inquiry. We plan to take our sample of 3 plants and re-perform these processes based on Hershey's capitalization policy to ensure proper and accurate compliance. As part of this process, we will examine costs like installation and shipments, closely checking if the costs were treated properly under the capitalization policy. Additionally, we will examine repair and maintenance expenses to find property that should be capitalized. Through vouching these expenses to supporting documentation like invoices, we can identify property that should have capitalized. We also plan to have this policy reviewed by an expert to examine its effectiveness, checking that these procedures are correct in the first place.

We also plan to include additional substantive procedures when examining depreciation due to the higher risk. As mentioned above, our reconciliation of the subsidiary ledgers to the general ledgers accounts checks the reasonability of Hershey's valuation. As with capitalization, Hershey has a policy summarizing its depreciation methods and the change in accumulated depreciation. In our audit, we will examine the policy for accuracy through recalculation. Salvage values in particular will be closely examined; we will use our knowledge of the proper value of the assets based on industry standards to ensure no improper manipulation is occurring. Once we recalculated depreciation, we will trace these amounts to the general ledger to verify management's assertion of completeness. Looking at Hershey's prior financial statements, accumulated depreciation has decreased in total before, benefitting the bottom line. As this provides an opportunity for misstatement, we plan to address potential problems in depreciation through tracing to dispositions.

CHAPTER 7: Complete the Audit

In the last stage of our audit, we will continue to gather sufficient and appropriate evidence after the financial statement date at the end of December, conducting roll-forward procedures, analytical procedures, and estimate reviews. Through our roll-forward procedures, we can apply the conclusion from our interim testing to the financial statement date (Louwers et al., 2015). We are required to perform analytical procedures at the end of our audit to review our conclusions and the presentation of the financial statements. Additionally, we must review Hershey's estimates like salvage value to determine if they are reasonable. Along with the estimates, we must ensure that all material contingencies have been properly disclosed and accounted for in the financial statements. Significant contingencies Hershey must disclose include its environmental contingencies. Hershey has dealt with asbestos in several of its properties, and so must disclose the impact of this environmental contingencies on its financial statements (The Hershey Company, 2018).

Hershey's legal contingencies involve several responsibilities for us as auditors (Louwers et al., 2015). First, we must request that Hershey send a letter to attorneys it employed during the period under audit that contains a list of potential litigation that could impact the financial statements, an evaluation of the likelihood of an unfavorable outcome, and estimates of potential losses. Once we receive this list, we will examine it closely, obtaining assurance that everything has been disclosed. As part of our audit documentation, we must obtain written representations from the client for certain pieces of evidence. To check the quality of our engagement, the manager, partner, and concurring partner will review the documentation. Between the date of the auditor's report and the financial statement date, subsequent facts affecting the financial statements could possibly be discovered. For Hershey, possible subsequent events could be a contamination of its products as they operate in the food industry, or weather destroying one of its plants. In the case that these events happen, we will either adjust the financial statements or disclose the information, depending on the timing of the events.

CHAPTER 8: Audit Report

After looking through and auditing the financials Hershey has presented to us as well as any other relevant documentation, we have found nothing to be materially misstated. We can independently provide Hershey with an unqualified opinion for their PP&E account for it is free of misrepresentation.

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