Chapter 15

Debt and Equity Capital
Source and Nature of Debt

- Long-term debt
  - Substantial in amount and often extend for periods of 20 years or more
  - Examples: Debentures, secured bonds and notes payable
  - Formal document creating bond indebtedness is indenture or trust indenture
    - May contain restrictive covenants
Financing cycle

- Activities of company designed to obtain capital funds
  - Involves issuance and repayment of debt and equity
  - Payment of interest and dividends
- Primary concern
  - Proper authorization by appropriate official in the company or by board of directors
Objectives for the Audit of Interest-Bearing Debt

1. Use the understanding of the client and its environment to consider inherent risk, including fraud risks, related to debt.

2. Obtain an understanding of internal control over debt.

3. Assess the risks of material misstatement of and design tests of controls and substantive procedures that:
   a. Substantiate the existence of debt and the occurrence of the related transactions
   b. Establish the completeness of recorded debt
   c. Verify the cutoff of transactions affecting debt
   d. Determine that the client has obligations to pay the recorded debt
   e. Establish the proper valuation of debt and the accuracy of transactions affecting debt
   f. Determine that the presentation and disclosure of debt are appropriate
Inherent Risk

- Similar to accounts payable in that understatement of debt is a major potential audit problem
- Disclosure of debt
  - Auditor must determine whether company has met all requirements and restrictions of debt agreement
Internal Control Over Interest--Bearing Debt

- Authorization by the board of directors
- Use of an independent trustee
- Interest Payments on Bonds and Notes Payable--Cash disbursement controls
Questions

- Are amounts of new debt authorized by appropriate management?
- Is an independent trustee used for all bond issues?
- Does a company official monitor compliance with debt provisions?
Audit Documentation

- Copy of loan agreement or indenture related to bond placed in permanent file
- Extract list of restrictions placed on company for auditor to test compliance
- Current workpapers
  - Analyses of ledger accounts for notes and bonds payable
  - Related accounts of interest and discount or premium
Substantive Tests of Interest-Bearing Debt (1 of 6)

- Obtain analyses of interest-bearing debt and related accounts
  
  a. Payment or other disposition of notes listed as outstanding in the previous year’s audit can be verified
  
  b. Propriety of individual debits and credits can be established
  
  c. Amount of year-end balance of the account is proved through the step-by-step examination of all changes in the account during the year
  
  d. Misstatements may be due to improper reporting of debt, incomplete recording of debt or improper amortization

- Examine copies of notes payable and supporting documents
Confirm interest-bearing debt

- Confirmed by financial institution
- Included with standard confirmation form for cash
- For others, use letter drafted on client’s letterhead
- Confirm dates of origin, due dates, unpaid balances of notes, interest rates, dates to which interest has been paid and collateral for notes
- Confirm bonds with trustee
Substantive Tests of Interest-Bearing Debt (3 of 6)

- Vouch borrowing and repayment transactions
  - Trace cash received from issuance of notes or bonds to validated copy of bank deposit slip and to bank statement
  - Examine payments and agree to repayment schedule
  - Examine canceled notes for retired notes
  - Trace disposition of any collateral used to secure canceled notes

- Perform analytical procedures
  - Determine overall reasonableness of interest expense by examining relationship of recorded interest to average principal amount of debt outstanding during year
Substantive Tests of Interest-Bearing Debt (4 of 6)

- Test computations of interest expense, interest payable, and amortization of discount and premium
- Evaluate compliance with debt provisions
  - Vouch payments to sinking fund
  - Maintenance of stipulated minimum levels of working capital
  - Examine evidence of insurance of pledged property
  - Compare amounts of management compensation and dividends paid to amounts allowed by agreements
- Verify authority for issuance of debt to corporate minutes
Substantive Tests of Interest-Bearing Debt (5 of 6)

- Review notes payable paid or renewed after the balance sheet date
- Perform procedures to identify notes payable to related parties
- Send confirmation letters about financing arrangements
  - Separate confirmation letter to verify details of financing arrangements.
  - Examples: Lines of credit or contingent liabilities
- Evaluate financial statement presentation and disclosure
Substantive Tests of Interest-Bearing Debt (6 of 6)

- Evaluate financial statement presentation and disclosure
  - Adequately describe:
    - Long-term debt payable in the current period
    - Restrictions imposed by long-term debt agreements
    - Unamortized bond premium or discount
Confirming Financial Arrangements

FIGURE 15.2
Illustrative Letter for Confirmation of Lines of Credit

Wallace Manufacturing, Inc.
1400 Main St.
Los Angeles, CA 90015

January 31, 20X5
Mr. Richard M. Smith
Senior Loan Officer
First United Bank
2330 Rounds Ave.
Los Angeles, CA 90010

Dear Mr. Smith,

In connection with an audit of the financial statements of Wallace Manufacturing, Inc., as of December 31, 20X4, and for the year then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on December 31, 20X4. Although we do not request or expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below.

1. The company has available at your financial institution a line of credit totaling $47 million.
2. The current terms of the line of credit are contained in the letter dated May 11, 20X2.
3. The amount of unused line of credit, subject to the terms of the related letter, at December 31, 20X4, was $19 million.
4. The interest rate at the close of business on December 31, 20X4, was 9.2%.
5. There are no requirements for compensating balances in connection with this line of credit.

Please confirm whether the information about the line of credit presented above is correct by signing below and returning this letter directly to our independent auditors, Warren & Clark, CPAs, 2100 Century Blvd., Los Angeles, CA 90055.

Sincerely,
Wallace Manufacturing, Inc.

By
Robert Barr
Counsel

Dear Warren & Clark, CPAs

The above information regarding the line of credit agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. [Note exceptions below or in an attached letter.]

________________________________________

________________________________________

First United Bank

By
Richard Smith, Senior Loan Officer
(Officer and Title)

2/20/XX
(Date)
Time of examination

- Small number of entries
- End of the year – often wait until after balance sheet date for many procedures
  - Test for unrecorded liabilities cannot usually be done before the balance sheet date
  - Evaluation of compliance with debt provisions
  - Tests of interest expense
  - Investigation of notes paid after year-end
Sources of owner’s equity

- Corporate accounts
  - Capital stock accounts
    - Preferred and common
  - Retained earnings
    - Prior period adjustments
  - Transactions generally few in number but material in amount
Objectives for the Audit of Owners’ Equity

1. Use the understanding of the client and its environment to consider *inherent risk*, including fraud risks, related to owners’ equity.

2. Obtain an understanding of *internal control* over owners’ equity.

3. Assess the risks of material misstatement of and design tests of controls and substantive procedures that:
   a. Substantiate the *existence* of owners’ equity and the *occurrence* of the related transactions
   b. Establish the *completeness* of recorded owners’ equity
   c. Verify the *cutoff* of transactions affecting owners’ equity
   d. Determine that the client has *obligations* to pay the recorded debt
   e. Establish the proper *valuation* of owners’ equity and the *accuracy* of transactions affecting owners’ equity
   f. Determine that the *presentation and disclosure* of owners’ equity are appropriate
Internal Control - Capital Stock
(1 of 2)

- Proper authorization of transactions by board of directors and corporate officers
- Segregation of duties in handling transactions
- Maintenance of adequate records
Board of director control of capital stock transactions

Large companies—Independent registrar and stock transfer agent control issuance of stock

Small companies--Control achieved by segregation of duties of authorization of transactions, custody of stock certificates, and recordkeeping
  - Stock certificate book
  - Stockholders’ ledger

Control over dividend payment
Audit Documentation

- Lead schedule for equity accounts
- Analysis of each equity account for the permanent file
  - Stock option plan
  - Permanent file list of shareholders and number of shares
Examine articles of incorporation, bylaws, and minutes for provisions relating to capital stock

- Information for each issue of capital stock
  - Number of share authorized and issued
  - Par or stated value
  - Dividend rates
  - Call and conversion procedures
  - Stock splits
  - Stock options, if any
Obtain an understanding of internal control over capital stock transactions

- Written description or flowchart from questionnaire
  - Does the company utilize the services of an independent registrar and stock transfer agent?
  - Are stockholders ledgers and transfer journals maintained?
  - Are entries in owners’ equity accounts reviewed periodically by an appropriate officer?
Obtain analyses of capital stock accounts
  - Including treasury stock
Account for proceeds of stock issues
Confirm shares outstanding
  - Request written by client on client’s letterhead but mailed by auditors
Reconcile shares outstanding with general ledger
  - Accounting for stock certificate numbers
  - Examining canceled certificates
  - Reconciling the stockholders ledger and stock certificate book with the general ledger
Determine the appropriate accounting is applied to employee stock compensation plans

- Accounting at fair value

Determine compliance with restrictions and preferences related to capital stock and disclosures are appropriate

- Stock options
Retained Earnings

- Analysis of retained earnings and any appropriations of retained earnings
- First year
  - Analysis covers the entire history of the retained earnings account
  - Credits from income summary
  - Debits from net losses, cash and stock dividends, appropriate reserves
    - Appropriates require specific authorization by board of directors
Dividends

- Determine the dates and amounts of dividends authorized
- Verify the amounts paid
- Determine the amount of any preferred dividends in arrears
- Review the treatment of unclaimed dividend checks
Complete description of each issue

- Title
- Par or stated value
- Dividend rate
- Conversion and call provisions
- Number of shares authorized, issued and in treasury
- Dividends in arrears
- Shares reserved for stock options or conversions
Time of Examination

- Few transactions but material in amount
- Analysis most efficient after close of period
- More time for first audit then continuing audit client
Partnerships

- Partnership contract
  - Auditor verifies distribution of net income in accordance with profit-sharing provisions
  - Maintenance of partners’ capital accounts at prescribed levels
  - Drawings
  - Loan accounts for partners
Sole Proprietorship

- Capital accounts
  - Net income
  - Withdrawals
  - Capital investments and additions traced to the cash and asset records
  - Ensure segregation of personal transactions from business