**Chapter Six:**

**Audit of Debt and Equity Capital**

Business corporations obtain substantial amounts of their financial resources by **incurring interest-bearing debt** and by **issuing capital stock**. The acquisitions and repayment of capital is sometimes referred to as the financing cycle. This transaction cycle includes the sequence of procedures for authorizing, executing, and recording transactions that involve bank loans, mortgages, bonds payables, and capital stock as well as the payments of interests and dividends. In this sections, the auditor’ approach to both debt and equity capital accounts shall be presented.

**6-1: Audit of Interest Bearing Debt**

Long term debt usually is substantial in amount and often extends over a longer time period. Debenture, secured bond, and notes payable (sometimes secured by mortgages or trust deeds) are the principal types of long-term debt. Debentures are backed only by the general credit of the issuing corporation and not by liens on specific assets. Since in most respects, debenture has the characteristics of other corporate bonds, we shall use the term bonds to include both debentures and secured bonds payable.

The formal document creating bond indebtedness is called the indenture or trust indenture. When creditors supply capital on a long-term basis, they often insist upon placing certain restrictions on the borrowing company. For example, the indenture often includes a restrictive covenant that prohibits the company from declaring dividends unless the amount of working capital is maintained above a specific amount. The acquisitions of plant and equipment, or the increasing of material salaries, may be permitted only if the current ratio is maintained at a specified level and if net income reaches a designed amount. Another device for protecting the long-term creditors is the requirement of a sinking fund or redemption fund to be held by a trustee. If these restrictions are violated, the indenture may provide that the entire debt is due on demand.

**6.1.1:The auditors’ objectives in the audit of interest-bearing debt are to:**

1. **Consider internal control** over interest-bearing debt
2. **Determine the existence** of recorded interest-bearing debt
3. **Establish the completeness** of recorded interest –bearing debt.
4. **Determine that the client has obligations** to pay the recorded interest-bearing debt.
5. **Establish the clerical accuracy** of schedules of interest-bearing debt.
6. **Determine that the valuation of interest-bearing debt** is in accordance with generally accepted accounting principles.
7. **Determine that the presentation and disclosure** of interest-bearing debt are appropriate, including disclosures of the major provisions of loan agreements.

In conjunction with the audit of interest-bearing debt, the auditors will also obtain evidence about interest expense, interest payables and bond discount and premium.

Many of the principles related to accounts payable also apply to audit of interest-bearing debt. As in the case of accounts payable the understatement of debt is a major potential audit problem. Related to disclosure of interest-bearing debt, the auditors must determine whether the company has met requirements and restrictions imposed upon it by debt agreements.

**6.1.2: Audit program for interest-bearing debt-** The audit program does not provide for the usual distinction between tests of controls and substantive testing. This is because; individual transactions will generally be examined for all large debt agreements. To document the internal structure, the auditors will usually prepare a written description as well as an internal control questionnaire. Questions included in a typical questionnaire are the following.

* Are all amounts of new interest-bearing debt authorized by appropriate management?
* Is an independent trustee used for all bond issues?
* Does a company official monitor compliance with debt provisions?
* Other relevant questions

Because, transactions are few in number, but large in dollar amounts, the auditors are generally able to substantiate the individual transactions. Therefore, testing of controls occurs through what actually amounts to dual-purpose transactions testing.

**The objective of major substantive testing procedures of interest bearing debt transactions and balances are given in the following table.**

|  |  |
| --- | --- |
| **Substantive Tests** | **Primary Audit objectives to be addressed** |
| 1. Obtain analysis of interest-bearing debt and related   accounts | Clerical accuracy |
| 1. Examine copies of notes payable and supporting   Documents   1. Confirm interest-bearing debt with payees or   appropriate third parties   1. Vouch borrowing and repayments transactions to   supporting documents. | Completeness  Existence and obligations |
| 1. Perform analytical procedures to test the overall   reasonableness of interest-bearing debt and interest  expense.   1. Test the computation of interest expense, interest   payable, and authorization of discount and premium | Completeness, Existence and valuations |
| 1. Evaluate whether debt provisions have been met 2. Trace authority for issuance of debt to corporate   minutes.   1. Review notes payable paid or renewed after the   balance sheet date.   1. Perform procedures to identify notes to related parties. 2. Send confirmation letters to financial institutions to   obtain information about financing arrangements.   1. Evaluate proper financial statement presentation and disclosure of interest-bearing debt and related transactions. |  |

**6-2: Audit of Owners Equity Capital and Retained earning**

Most of this section is concerned with the audit of stockholder’s equity accounts of corporate clients; the audit of owners’ equity in partnerships and sole proprietorships is discussed briefly near the end of the chapter.

Owners’ equity of corporate clients consists of capital stock accounts (preferred and common) and retained earrings. Balances in the capital stock accounts change when the corporation issues or repurchases stock. The accounts balances are not affected by transfers of ownership of shares from one shareholder to another. Retained earnings are normally increased by earnings and decreased by dividends payments. Additionally, a few journal entries (e.g. prior period adjustments) may directly affect retained earnings. Transactions in the owners’ equity accounts are generally few in number, but material in amounts. No change may occur during the year in the capital stock accounts, and perhaps only one or two entries will be made to the retained earnings accounts.

**6.2.1: The auditors’ objectives of auditing owners’ equity**

The auditors’ objectives in the audit of owners’ equity are to:

1. **Consider internal control** over owners’ equity
2. **Determine the existence** of recorded owners’ equity
3. **Establish the completeness** of recorded owners ‘equity.
4. **Determine that the valuation of owners’ equity** is in accordance with generally accepted accounting principles.
5. **Establish the clerical accuracy** of schedules of owners’ equity
6. **Determine that the presentation and disclosure** of owners’ equity are appropriate.

In conjunction with the audit of owners’ equity accounts, the auditor will also obtain evidence about the related accounts of dividends payables and capital stock discounts and premiums. Evidence is also gathered regarding the proper cutoff of cash receipts and disbursements relating to the equity accounts.

**Internal control over owner’s Equity-** There are three principal elements of strong internal control over capital stock and dividends. These are:

1. The proper authorization of transactions by the board of directors and corporate officers
2. The segregation of duties in handling these transactions ( preferably the use of independent agents for stock registration and transfer and for dividend payments)
3. The maintenance of adequate records

**6-2.2: Audit program for capital stock**

The following procedures are typical of the work required in many engagements for the verification of capital stock.

1. Obtain an understanding of internal control over capital stock transactions
2. Examine articles of incorporation, bylaws, and minutes for provisions in relation to capital stock. ***( To determine existence, completeness, and obligations)***
3. Obtain or prepare analyses of the capital stock accounts. ***( To establish clerical accuracy)***
4. Accounts for all proceeds from stock issues. ***( To establish existence, completeness and obligations and valuation )***
5. Confirm shares outstanding with the independent register and stock transfer agent***.( To establish existence, completeness and obligations )***
6. For a corporation acting as its own stock register and transfer agent, reconcile the stockholders records with the general ledger. ***( To determine existence, completeness, and obligation)***
7. Determine compliance with stock option plans and with other restrictions and preferences pertaining to capital stock***.( To establish presentations and disclosure)***

Capital stock transactions are usually few in number; consequently, the auditors usually, substantiate all transactions rather than obtaining evidences to reduce their assessment of control risk. In additions to the proceeding steps, the auditors must, determine the appropriate financial statements presentation of capital stock.

**6-2.3: Audit of retained earning and dividends**

The audit work of retained earnings and dividends includes two major steps. These are:

**1) The review of retained earnings and any appropriation of retained earnings-** the auditors should review the changes in retained earning during the year.

**Credits** to retained earning accounts ordinarily represent amounts of net income transferred from the income summary account.

**Debit** to Retained earnings accounts ordinarily includes entries for net losses, cash and stock dividends, and for the creations or enlargement of appropriated reserve.

Appropriation of retained earnings requires specific authorization by the board of directors. The only verification necessary for these entries is to ascertain that the dates and amounts correspond to the actions of the board.

**2) The review of dividend procedures for both cash and stock dividends**- - in the verification of cash dividends, the auditors usually, will perform the following steps

* 1. Determine the dates and amounts of dividends authorized
  2. Verify the amounts paid
  3. Determine the amount of any preferred divided is arrears
  4. Review the treatment of unclaimed dividend checks.

The auditors’ analysis of divided declarations may reveal the existence of cash dividends declared but not paid. These dividends must be shown as liabilities in the balances sheet. The auditors also may review the procedures for handling unclaimed dividends and ascertain that these items are recognized as liabilities. The amount of any accumulated divided in arrears on preferred stock should be computed. In the verification of dividend there is additional responsibility of determining that the proper amounts have been transferred from retained earnings to capital stock and paid-in-capital accounts for both large and small stock dividends.

**Presentations-** the presentations of capital stock in the balance sheet include a complete description of each issue. Information to be disclosed includes the title of each issue; par or stated value; dividend rate, in any; dividend preference; conversion and call provisions; number of shares authorized, issued and in treasure; dividends in arrears if any ; and shares reserved for stock options or for conversions.

-Treasury stock preferably is shown in the stockholders’ equity section, at cost, as a deduction from the combined total of paid-in capital and retained earnings.

- Changes in retained earning during the year may be shown in a separate statement or combined with the income statement. One of the most significant points to consider in determining the presentation of retained earnings in the balance sheet is the existence of any restriction on the use of this retained income.

**Disclosure**-In evaluating client disclosure, the auditor must be aware that changes in retained earning during the year may be shown in a separate statement or combined with the income statement. A combined statement of income and retained earnings often is presented. In this form of presentation, the amount of retained earnings at the beginning of the year is added to the net income figure, dividends declared are subtracted from the subtotal, and the final figure represents the new balances of retained earning.

Existence of any restriction on the use of retained that might be resulted form the agreements with banks, bondholders, and other creditors commonly impose limitations on the payment of dividends etc must be fully disclosed in the note to the financial statements.

**6.2.4: Audit of statements of cash flows**

The statement of cash flows is prepared from other financial statements and from analysis of **increase** and **decrease** in selected account balances. The amounts included in the statements of cash flows are audited in conjunction with the audit of balance sheet and income statements accounts. Thus, limited substantive testing is necessary. The auditors merely compare the amounts included in the statements of cash flows to other financial statements balances and amounts included in the audit working papers.

Since receipts and payments must be classified in the statements of cash flows as to whether they are from operating, investing or financing activities, the presentation and disclosure audit objectives is especially important. The auditors must determine that the concept of cash or cash and cash equivalents analyzed in the statements agrees with an amount shown on the balances sheet. Finally, the auditors should ascertain that a statement of cash flows is presented for early year for which an income statement is presented