Review Questions

15–1 A trust indenture is drawn to protect the position of bondholders by imposing restrictions upon the borrowing corporation. One of the most common of these restrictions is that the company must not declare dividends that would cause the working capital to fall below a specified amount. An overly generous dividend policy could leave the company so short of cash as to endanger the position of bondholders.

15–2 Restrictions commonly imposed on a borrowing company by long-term creditors relate to (a) dividend payments, (b) acquisition of property and equipment, (c) increases in managerial compensation and (d) acquisition of additional debt. Such actions are usually permitted only if they will not reduce the current ratio and amount of working capital below specified levels, or increase the debt to equity ratio above a specified level. Creation of a sinking fund is another common requirement designed to assure that cash will be available to pay the long-term debt at maturity.

15–3 The trustee protects the interests of the bondholders by accounting for the issuance and redemption of bond certificates, determining that provisions of the borrowing agreement are observed by the corporation, and reporting periodically on the amount of the liability and of any related sinking fund. This work by the trustee leaves little opportunity for either error or fraud in the issuance, servicing, or redemption of bonds.

15–4 The auditors should request from the trustee responsible for the debenture issue an exact description of the issue, a statement of the amount outstanding, amounts redeemed or purchased during the year, and the balance of the sinking fund.

15–5 The sources of information for preparation of the notes payable analysis for the audit working papers are the notes payable register (if one is maintained), or duplicate copies of the notes issued. Information is also obtainable from the general ledger controlling account for notes payable and from the paid notes that matured during the year. Information about interest expense, interest payable, and prepaid interest may be obtained from the cash disbursements journal and the general ledger.

15–6 The confirmation of notes payable to financial institutions is accomplished as part of the procedure for confirming cash on deposit.

15–7 Testing the reasonableness of the Interest Expense account may disclose the existence of unrecorded notes payable upon which interest payments are being made.

15–8 To satisfy themselves that all interest-bearing liabilities of the client are recorded, the auditors include questions about liabilities to financial institutions in the standard confirmation for deposits and loans at financial institutions, review minutes of directors' meetings, analyze the Interest Expense account
to detect payments applicable to unrecorded long-term debt, and review the sources of cash receipts and the financing of property acquisitions. A liability representation stating that all known liabilities have been recorded is also obtained from the client.

15–9 Payments of notes during the course of the examination may furnish evidence supplementing confirmation with payees. Renewal of notes payable may affect the balance sheet presentation of the liability.

15–10 The auditors do not judge the legality of a bond issue; they do, however, need to study the bond indenture carefully so that they can determine the information to be presented in the balance sheet and the notes to the financial statements. This study is also necessary so that they can determine that standard procedures for authorization have been followed and that the company is complying with any restrictive covenants pertaining to working capital, dividends, and so on.

15–11 The 30-year bonds payable issued by Mansfield Corporation should be classified as a current liability when the time remaining to maturity is no more than one year or the operating cycle (whichever is longer). This change in classification from long term to current should be made only if the bonds are to be paid from current assets. If Mansfield has arranged to refinance the maturing bonds on a long-term basis, there will be no use of current assets to pay the bonds and they will continue to be shown as a long-term liability.

15–12 No, the points covered do not constitute a sufficient verification of long-term liabilities. Other matters include consideration of internal control, the extent of compliance with restrictions imposed by financing agreements, computation of interest expense and accrued interest payable, identification of pledged assets, and determination of proper balance sheet presentation of long-term liabilities and related data.

15–13 Transactions affecting owners' equity accounts are generally few in number but substantial in amount; the audit time required for this part of the examination is relatively small. Detailed review of individual transactions is therefore appropriate; the tests of controls that are so important for assets and current liabilities are much less applicable to owners' equity.

15–14 The most important single internal control procedure relating to capital stock transactions consists of utilizing the services of an independent registrar and stock transfer agent. This action eliminates the problem of handling stock certificates and the danger of overissuance.

15–15 The primary responsibility of an independent registrar is to avoid overissuance of stock. This entails the countersigning of each certificate issued and the maintenance of records of certificates issued and canceled.

15–16 The auditors verify the general ledger account for capital stock by obtaining or preparing a list of outstanding shares from the open stubs in the stock certificate book. This list is also reconciled with the stockholder ledger that shows accounts with individual stockholders.

15–17 Stock certificates are serially numbered by the printer and may be delivered to the corporation in the form of a bound book with serially numbered stubs attached. As each certificate is issued, the date, name of holder, and number of shares are filled in on both the certificate and the stub. A list of outstanding shares may be prepared at any time from the open stubs. The purpose of the stock certificate book is to prevent the overissuance of stock and to maintain control over capital stock transactions.

15–18 The work done by the auditors in the examination of Capital Stock accounts during an initial audit includes the analysis of these accounts for the entire period since the organization of the corporation,
as well as obtaining copies of the articles of incorporation, bylaws, and minutes of meetings of directors and stockholders. In subsequent audits, this work is merely brought up to date by adding an analysis of the events of the current period.

15–19 The list of stockholders would usually be prepared from the stockholder ledger. This subsidiary ledger is maintained in terms of numbers of shares, rather than in dollars. It contains a separate account with each stockholder, showing the shares acquired, shares disposed of, and running balance of shares owned. Each entry is also referenced by certificate number.

15–20 When assets other than cash are received for capital stock, the values assigned such assets should be formally stated by resolution of the board of directors. The par value of the shares issued for the assets is not an indication of the value received. If the values set by the board appear unreasonable, in relation to the market value of the stock or the appraised value of the assets, the auditors are obligated to investigate further, and to question whether valuation of the assets is in accordance with generally accepted accounting principles.

15–21 Since the Treasury Stock account was not encountered by the auditors during their first audit of the corporate client, we may assume that the company acquired treasury shares during the year by purchase, donation from shareholders, in exchange for cancellation of a receivable, or some similar manner. To determine just how these shares were acquired and whether they are properly stated at the amount of $306,000, the auditors should begin by analyzing the Treasury Stock account. The treasury stock certificates should be inspected and tied in with the account analysis. In verifying the entries to the account, the auditors should refer to minutes of directors' meetings for authorization to acquire the treasury shares and the price authorized. The auditors should also verify the payments made by reference to paid checks and stockbroker's advice of purchase, if available. Finally, the auditors should determine in the light of applicable state statutes whether the acquisition of treasury shares was permissible, and whether retained earnings should be restricted by the cost of the shares.

15–22 Verification of this entry in the Retained Earnings account would include tracing the entry to the general journal and the dividend declaration to the minutes of directors' meetings. From the minutes, the auditors would determine the nature of the dividend (cash or stock), the amount per share, date of declaration, date of record, and date of payment. The total amount to be distributed should also be determined by extending the amount per share by the total number of shares outstanding. If the payment date falls after the balance sheet date, the auditors should ascertain that any cash dividend payable is included among the current liabilities and that adequate disclosure is made for any stock dividend.

15–23 Long-term debt contracts frequently place restrictions on the use of all or a portion of the retained earnings as a source of dividend payments. This restriction would come to the attention of the auditors in their study of the indenture or other financing agreement.

Retained earnings might also be restricted because of a default in the payment of bond interest or because of dividends in arrears on cumulative preferred stock. The auditors' regular procedures in verification of interest expense and dividend payments would bring these restrictions to light.

Retained earnings might also be restricted by reason of actions by the board of directors in making appropriations for specific purposes, or by reason of the purchase of treasury stock. Review of the corporate minutes and of the Treasury Stock account would disclose these restrictions.

15–24 Except during the first audit of a client, there is usually little work that can be done to advantage on the owners' equity accounts prior to the balance sheet date. Since there are usually few entries in these accounts, little time is saved by interim work.
15–25 A note to the financial statements should indicate that 20,000 shares of common stock are being held in reserve for possible exercise of stock options by officers. It should also give all pertinent details of the stock option agreements.

15–26 One of the most common errors encountered in the examination of the capital and drawing accounts of a sole proprietorship is the intermingling of business and personal transactions, which may make it difficult to distinguish between business capital and personal resources. Business expenses may have been paid from personal funds without crediting the proprietorship accounts, and personal expenses may have been paid from business funds and recorded by charges to expense rather than to the drawings account.

Questions Requiring Analysis

15–27 Since the auditors will already have in their working papers from prior years' audits the terms and requirements of the mortgage note, their work in the current examination will consist of determining that there has been no change in the principal amount of the notes, that interest payments have been made in accordance with the terms of the note, and that any requirements as to insurance or other such matters have been observed. The balance payable of the note will be established by direct confirmation with the mortgagee. The propriety of the interest payments can be tested by independent computation of the interest charges. Any restrictions imposed by the borrowing agreement as to insurance, dividends, other borrowing, or expenditures for property and equipment will be recorded in the audit working papers. The investigation of these points will, of course, depend upon the precise nature of the restrictions imposed.

15–28 The existence of a zero balance at year-end does not preclude the need for an audit of the Notes Payable to Officers account. Such an account reflects related party transactions. It is important that the independent auditors ascertain that the zero balance resulted from a bona fide repayment of the officers' notes, rather than from a temporary "window-dressing" repayment with the loan being reestablished subsequent to the balance sheet date. The auditors are also concerned with proper authorization and recording of transactions occurring during the year.

15–29

a. Armada's default on the note maturing September 30 must be disclosed in notes to the financial statements for the year ended August 31. This default could affect Armada's status as a going concern, and is a subsequent event requiring disclosure.

b. Even if the default is properly disclosed, the auditors may be unable to issue a standard unqualified opinion on the financial statements. The financial statements have been prepared under the assumption that Armada is a going concern. If this assumption has become of questionable validity, the auditors may have to add explanatory language to their report about Armada's ability to remain a going concern.

15–30

a. Yes, the auditors should act upon the information obtained from the telephone call. The auditors should not engage in eavesdropping, but there is no suggestion of such action in this instance. Auditors certainly are not supposed to close their ears or eyes to the happenings about them during the course of an examination. On the contrary, they should be alert to recognize significant evidence in any form. The auditors should immediately inform the president of their interest in accommodation endorsements or any other form of contingent liability.

b. The contingent liability for the accommodation endorsement should be disclosed in a note to the June 30 balance sheet. The note should indicate that the contingent liability was ended during July by payment by the maker at maturity. The purpose of the disclosure is to make
readers of the statement aware that Columbia Corporation has in the past incurred contingent liabilities by accommodation endorsement of notes. The reader is thus warned of the possibility of such situations arising again, although no such specific suggestion should be made in the note to the financial statements. Inclusion of the note may also have the incidental effect of impressing upon the client the importance of contingent liabilities in a statement of financial position.

c. The contingent liability might have been detected by the following auditing procedures:

1. Obtain a liability representation from the client. Insistence upon a written statement by officers concerning any loss contingencies of which they have knowledge is probably the most effective way of detecting such items.

2. Review the minutes of directors' meetings. Prior approval of such endorsements should be obtained from the board before an officer endorses a note of another company. The bylaws may prohibit such lending of the company's credit.

3. Send a confirmation to the client's financial institution specifically confirming the details of any contingent liabilities.

4. Request the attorneys of the client to advise the auditors directly of any contingent liability of which the attorneys have knowledge. It is possible that the client may have discussed with the attorneys the risk involved in accommodation endorsements.

15–31

a. Despite the fact that the options have a higher option price than the stock’s current price, they may well have value. Call options with option prices that are higher than the related stock prices are traded on option markets every day. Management should have a business valuation expert (specialist) value the options to determine the appropriate amount of compensation cost to be recognized.

b. (1) Obtain a copy of the stock option plan for the auditors' permanent file and become thoroughly familiar with its provisions.

(2) Trace the approval of the plan to minutes of directors’ and stockholders’ meetings.

(3) Prepare a working paper for the permanent file showing the number of shares authorized by the plan, and the number granted, exercised, and expired each year. Design the working paper so that data can be added each year.

(4) Verify the number of shares granted in the current year by reference to minutes of directors’ meetings. Verify market price at date of grant by reference to financial publications.

(5) Compute the number of options expired during the year and the number outstanding at the balance sheet date.

(6) Engage a specialist or use management’s specialist to value the stock options.

(7) Evaluate the reasonableness of the estimated value of the options used to compute compensation cost. This would include evaluating the qualifications and objectivity of the specialist. The auditors should also obtain an understanding of the methods and assumptions used by the specialist, make appropriate tests of data provided to the specialist, and evaluate whether the specialist’s findings support the related assertions in the financials statements.
Objective Questions

15–32 Multiple Choice Questions

a. (3) The client will not receive proceeds related to redemption of its interest-bearing debt—it will pay off the debt.

b. (1) Auditors will test the relationship between interest payments and recorded long-term liabilities. When interest payments seem too high, it may be due to the existence of unrecorded liabilities. Also, the process of performing procedures to determine whom interest is paid to may reveal unrecorded debt.

c. (2) When debt provisions are violated, long-term debt often becomes immediately payable, and therefore, a current liability.

d. (2) A registrar and a transfer agent keep information on the shares issued, outstanding, and the owners of that stock.

e. (2) It is not customary to confirm stockholdings by direct communication with individual stockholders. For an actively traded stock, contacting individual stockholders would be very costly and not likely to produce a satisfactory proportion of replies.

f. (1) The auditors should trace treasury stock purchase transactions to the certificates on hand. If the certificates are not on hand, they should be confirmed directly with the custodian. The articles of incorporation, answer (2), will not provide information on the details of specific stock issuances and treasury stock transactions. There is no interest on the treasury stock, and accordingly, answer (3) doesn't relate directly to treasury stock. Finally, it is far more likely that the overall board of directors, not the audit committee, will approve treasury stock transactions. Therefore, answer (4) is not correct.

g. (1) Transactions in the owners’ equity accounts are very few in comparison with the volume of entries in the other three groups. Consequently, the audit time required for owners’ equity is usually much smaller than for revenue, assets, or liabilities.

h. (3) The bond trustee will be able to provide information on both the sinking fund transactions and the year-end balance.

i. (2) The auditors' examination of long-term debt always includes an examination of copies of debt agreements to ensure the client is not in violation of the covenants of these agreements. Answer (1) describes a procedure that is not performed. Answers (3) and (4) describe procedures that may be performed but they pertain more directly to other accounts.

j. (1) The client’s board of directors should approve all capital stock transactions. Answer (2) is incorrect because there will be no cash receipt for stock repurchase transactions. Answers (c) and (d) are incorrect because cash disbursements will not be recorded and numbered stock certificates will not be on hand after stock sales.

k. (3) An audit objective for owners’ equity is to determine that presentation and disclosure are appropriate. Answer (1) is incorrect because owners’ equity does not include long-term debt. Answer (2) is incorrect because common stock should not be valued
at current market value. Answer (4) is incorrect because the term “equity accounting rule valuations” is of uncertain meaning.

l. (1) A common difficulty for a sole proprietorship is segregating personal and business assets and personal net worth. For example, credit cards and cash accounts may be used for both personal and business use, thus complicating the accounting process.

m. (4) Answer (4) is correct because companies frequently require that direct borrowings on notes payable be authorized by the board of directors; accordingly, auditors will determine whether proper policy has been followed.

n. (4) Answer (4) is correct because the primary responsibility of the stock registrar is to prevent any over issuance of stock, and thereby verify that the stock is issued properly.

o. (1) Canceled stock certificates should be defaced and attached to corresponding stubs as is done with voided checks. The objective of the control is to prevent reissuance.

p. (1) Answer (1) is correct because the presentation and disclosure assertion deals with whether particular components of the financial statements—such as loan agreement covenants—are properly classified, described, and disclosed. The other assertions are less directly related.

q. (1) Answer (1) is correct because the board of directors will, in general, authorize changes in stockholders’ equity.

15–33 Definitions

a. (6) Stock registrar.
b. (7) Stock transfer agent.
c. (3) Sinking fund.
d. (8) Treasury stock.
e. (9) Trust indenture.

Problems

15–34 SOLUTION: Summerford Company (Estimated time: 25 minutes)

a. Review balance sheets at year-end and determine that the current ratio is in excess of 1.5.

b. Determine the company’s profitability situation and test whether any dividends paid have been appropriate.

c. Determine that the restriction is properly disclosed in the financial statement notes.

d. Vouch president and vice president salaries. Determine that any such payments in sum do not exceed the total.
e. Vouch and determine the timeliness of payments.

15–35 SOLUTION: Griffin Equipment Company (Estimated time: 40 minutes)

a. An audit conducted while the note was outstanding should have disclosed the understatement of liabilities through the procedure of confirming outstanding notes payable with the holders. If a duplicate copy of the note was on file, comparisons of this document with the ledger account may have revealed a discrepancy.

b. An audit subsequent to payment of the note might have disclosed the fraud by: (1) discovery that the balance of the accounts payable control account was $20,000 less than the accounts payable subsidiary ledger, or (2) comparison of vendors' monthly statements with entries in the client's accounts.

c. The basic weakness in internal control in Griffin Equipment Company is the concentration of all accounting and financial matters in the hands of one employee. Hopkins has custody of cash, is in charge of accounting records and is solely responsible for all phases of many transactions. Under this organizational setup, no single control procedure or group of procedures can overcome the basic weakness. Cash handling and recordkeeping must be segregated if internal control is to be adequate. Two or more employees must participate in every transaction. Barton should accept the necessity of taking an active part in financial management of the business.

Two specific suggestions are also appropriate. When notes or checks are prepared by an employee for the signature of an executive, the executive should mail the note or check after signing it; under no circumstances should these instruments be returned to the employee who prepared them. Secondly, Barton should arrange for regular audits by a firm of independent CPAs and should also ask the public accountants to make a study of the company's financial and accounting operations with a view to outlining satisfactory internal control. Initially, Barton may feel that he cannot afford such services; but, actually, he cannot afford to be without them.

15–36 SOLUTION: Lowe Company (Estimated time: 10 minutes)

a. The evidence obtained most directly addresses existence, occurrence, completeness, and cutoff. Existence is addressed as both confirmations address the stock outstanding. Occurrence, completeness, and cutoff are most directly addressed by the transfer agent’s confirmation that addresses transfers of stock holdings throughout the year under audit.

b. Additional audit procedures include:
   - Obtaining an understanding of internal control over capital stock transactions.
   - Examining the articles of incorporation, bylaws, and minutes for provisions relating to capital stock.
   - Using the information obtained from the registrar and the transfer agent to assist in preparing analyses of the capital stock accounts.
   - Accounting for all proceeds from stock issues during the year.
   - Determining that compliance with restrictions and preferences pertaining to capital stock and disclosures are appropriate.
PHOENIX CORP.
Proposed Adjusting Journal Entries
April 30, 20X1

(1) Paid-In Capital in Excess of Stated Value 32,000
   Printing Expense* 2,500
   Legal Fees* 17,350
   Accounting Fees* 12,000
   SEC Fees* 150
To charge costs of 5/1/X0 and 2/2/X1 to stock issuances to correct account.

(2) Provision for Income Taxes* 17,600
   Income Taxes Payable 17,600
To increase income tax provision for effect of AJE 1: 55% × $32,000 = $17,600

*Since client has closed accounts, the client should debit or credit Retained Earnings rather than the expense account named.

(3) Retained Earnings 35,500
   Capital Stock 50,000
   Paid-In Capital in Excess of Stated Value 38,000
   Stock Dividend to Be Issued 47,500
To correct 4/28/X1 entry for declaration of stock dividend. Dividend should have been recorded as $85,500 ($90 × 950 shares**), rather than $50,000. Capital Stock should not have been credited since shares had not been issued. Of the $85,500, $47,500 ($50 stated value × 950 shares) is a stock dividend to be distributed and $38,000 is additional paid-in capital.

**On 4/28/X1, 9,500 shares were outstanding (10,000 shares issued, less 500 shares held in treasury). Treasury stock does not receive stock dividend. Thus, dividend = 950 shares (10% × 9,500 shares).
b. PHOENIX CORP.
Partial Balance Sheet
April 30, 20X1

Capital stock, no par value, 100,000 shares authorized,
stated value $50 per share:
Issued—10,000 shares, of which 500 shares are
in treasury $ 500,000
To be issued as stock dividend—950 shares 47,500
$ 547,500
Paid-in capital in excess of stated value 258,500
Retained earnings ($40,000, representing cost of
treasury stock, unavailable for dividends) 728,900
$1,534,900
Less cost of treasury stock 40,000
$1,494,900