**Chapter 15**

**Debt and Equity Capital**

**True / False Questions**

1. The formal documentation creating bond indebtedness is called the indenture.   
**TRUE**

2. Registered bondholders receive periodic interest payments without any action on their part.   
**TRUE**

3. The auditors are required to confirm bond holdings directly with the bondholders.   
**FALSE**

4. The auditors should determine that the issuance of bonds was approved by the company's stockholders.   
**FALSE**

5. Long-term liabilities that are maturing must always be classified as a current liability.   
**FALSE**

6. Corporations maintain either a stock certificate book or a stockholders' ledger.   
**FALSE**

7. Dividends should be authorized by the stockholders of the corporation.   
**FALSE**

8. The auditors generally refer to provisions in the partnership agreement when auditing the allocation of partnership income.   
**TRUE**

9. When an independent registrar and stock transfer agent is used, it is likely that the auditor will confirm the number of shares outstanding with those parties rather than the shareholders.   
**TRUE**

10. For a continuing client, the auditors will often find that audit time required for capital stock is small in relation to the dollars recorded in the accounts.   
**TRUE**

**Multiple Choice Questions**

11. A registrar/transfer agent system relating to capital stock is most likely used by:   
A. A small, nonpublic company.  
**B.** A large, publicly traded company.  
C. All companies must use this type of system.  
D. No companies use this system anymore.

12. In auditing long-term debt, an auditor would be most likely to:   
A. Perform analytical procedures on the bond prenumbered discount accounts.  
B. Examine documentation of assets purchased with bond proceeds for liens.  
**C.** Compare interest expense with the long-term debt amount for reasonableness.  
D. Confirm the existence of individual long-term debt holders at year-end.

13. An auditor obtains evidence of stockholders' equity transactions for a publicly traded company by reviewing the entity's:   
**A.** Minutes of board of directors meetings.  
B. Registrar's record of interbank transfers.  
C. Canceled stock certificates.  
D. Treasury stock certificate book.

14. Which of the following most likely would approve the issuance of notes payable?   
A. Controller.  
B. Payroll.  
C. Personnel.  
**D.** Treasurer.

15. Internal control over bonds payable is best when:   
**A.** The company utilizes the services of a bond trustee.  
B. The company segregates approval from issuance of the bonds.  
C. Bonds are countersigned by two officers.  
D. Bonds are serially numbered.

16. The auditor's program to examine interest-bearing debt most likely will include steps that require:   
A. Comparing the book value of the debt to its year-end market value.  
**B.** Vouching borrowing and repayment transactions.  
C. Verifying the proper presentation of the debt through the use of confirmations.  
D. Inspecting the accounts payable subsidiary ledger for unrecorded interest-bearing debt.

17. Bond transactions are normally confirmed with:   
A. Individual holders of retired bonds.  
B. Recomputation procedures performed using interest expense.  
**C.** The bond trustee.  
D. Comparisons of retired bonds with those outstanding.

18. Company A does not employ an independent stock transfer agent, but rather issues its own stock and maintains its stock records. When outstanding shares are transferred from one holder to another the certificate of the selling shareholder should be:   
**A.** Canceled (generally by perforation) and attached to the certificate book.  
B. Destroyed to prevent fraudulent reissuance.  
C. Retained by the selling shareholder.  
D. Sent to the state's registrar of investment securities.

19. Which of the following procedures is likely in the audit of capital stock?   
**A.** Examine all outstanding stock certificates for completeness.  
B. Account for the proceeds from stock issues.  
C. Reconcile shares outstanding with the general ledger.  
D. Evaluate compliance with stock option plans.

20. When the auditors obtain an understanding of internal control for the financing cycle documentation will frequently include a written description as well as a(n):   
A. List of audit objectives.  
B. Decision table.  
C. Summary of tests of controls.  
**D.** Internal control questionnaire.

21. Which of the following is not a primary objective in the audit of interest-bearing debt?   
A. Establish the completeness of recorded interest-bearing debt.  
**B.** Establish the legality of outstanding debt.  
C. Determine that debt is properly valued.  
D. Determine that the presentation and disclosure of interest-bearing debt is appropriate.

22. In which of the following accounts would one expect a related party transaction to be easiest to detect?   
A. Accounts receivable.  
B. Accounts payable.  
**C.** Notes payable.  
D. Cash.

23. For audit purposes, a corporation's articles of incorporation are normally:   
A. Copied and placed on the owners' equity lead schedule.  
**B.** Copied and placed in the permanent file.  
C. Confirmed with the transfer agent.  
D. Ignored since they are normally considered to be related to the internal control structure.

24. The audit approach for acquired treasury stock will normally include:   
A. Confirmation with shareholders.  
**B.** Inspection of certificates.  
C. Inspection of cash receipts entries.  
D. Recomputation of all gains and losses.

25. Changes in capital stock accounts should normally be approved by:   
**A.** The board of directors.  
B. The audit committee.  
C. The stockholders.  
D. The president.

26. For a large publicly traded client the auditors' examination of capital stock accounts will normally include:   
A. Analysis of capital stock accounts.  
B. Confirmation of shares issued with the independent registrar.  
C. Accounting for the proceeds of major stock issues.  
**D.** Reconciliation of a stock certificate book with the general ledger.

27. For a corporation that does utilize the services of an independent registrar and stock transfer agent, which of the following represents a weakness in internal control over stock issuance?   
A. Stock certificates are prenumbered.  
**B.** Stock certificates are signed immediately upon receipt from the printer.  
C. Stock certificates are in the exclusive custody of a responsible officer.  
D. Stock certificates require the signature of two officers.

28. A primary responsibility of a registrar of capital stock is to:   
A. Determine that dividends paid do not exceed the amount allowable by law.  
B. Act as an independent third party between the board of directors and outside investors concerning merger, acquisition, and other major decisions.  
**C.** Avoid any over issuance of stock.  
D. Maintain detailed stockholder records and carrying out transfers of stock ownership.

29. Which of the following is an auditor most likely to confirm from the transfer agent and registrar?   
**A.** Total shares of stock issued.  
B. Restrictions on the payment of dividends.  
C. Total market value of outstanding shares of stock.  
D. Gains from sale of treasury stock.

30. The auditors' program for the examination of long-term debt should include steps that require the:   
A. Verification of the existence of the bondholders.  
**B.** Examination of any bond trust indenture.  
C. Inspection of the accounts payable subsidiary ledger.  
D. Investigation of credits to the bond interest income accounts.

31. During an audit of a publicly-held company, the auditors should obtain written confirmation regarding debenture transactions from the:   
A. Debenture holders.  
B. Client's attorney.  
C. Internal auditors.  
**D.** Trustee.

32. Auditors often request that the audit client send a letter of inquiry to those attorneys who have been consulted with respect to litigation, claims, or assessments. The primary reason for this request is to provide the auditor with:   
A. An estimate of the dollar amount of the probable loss.  
B. An expert opinion as to whether a loss is possible, probable or remote.  
C. Information concerning the progress of cases to date.  
**D.** Corroborative audit evidence.

33. The primary reason for preparing a reconciliation between interest-bearing obligations outstanding during the year and interest expense presented in the financial statements is to:   
A. Evaluate internal control over securities.  
B. Determine the validity of prepaid interest expense.  
C. Ascertain the reasonableness of imputed interest.  
**D.** Detect unrecorded liabilities.

34. An audit program for the examination of the retained earnings account should include a step that requires verification of the:   
A. Market value used to charge retained earnings to account for a two-for-one stock split.  
B. Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.  
**C.** Authorization for both cash and stock dividends.  
D. Gain or loss resulting from disposition of treasury shares.

35. During its fiscal year, a company issued, at a discount, a substantial amount of first-mortgage bonds. When performing audit work in connection with the bond issue, the independent auditor should:   
A. Confirm the existence of the bondholders.  
**B.** Review the minutes for authorization.  
C. Trace the net cash received from the issuance to the bond revenue account.  
D. Inspect the records maintained by the bond trustee.

36. When no independent stock transfer agent is employed and the corporation issues its own stocks and maintains stock records, canceled stock certificates should:   
**A.** Be defaced to prevent reissuance and attached to their corresponding stubs.  
B. Not be defaced but segregated from other stock.  
C. Be destroyed to prevent fraudulent reissuance.  
D. Be defaced and sent to the Secretary of State.

37. An auditor should trace corporate stock issuances and treasury stock transactions to the:   
A. Numbered stock certificates.  
B. Articles of incorporation.  
C. Transfer agent's records.  
**D.** Minutes of the board of directors.

38. The auditor can best verify a client's bond sinking fund transactions and year-end balance by   
A. Confirmation with individual holders of retired bonds.  
**B.** Confirmation with the bond trustee.  
C. Recomputation of interest expense, interest payable, and amortization of bond discount or premium.  
D. Examination and count of the bonds retired during the year.

**Essay Questions**

39. To establish effective internal control over a corporation's stock transactions, the corporation should utilize the services of a independent registrar and transfer agent.   
a. Describe the functions performed by the stock registrar.  
b. Describe the functions performed by the transfer agent.  
c. Describe the information that is typically requested by the auditors in a confirmation sent to the registrar.

a. The stock registrar controls the corporation's issuance of stock to avoid overissuance.  
b. The stock transfer agent maintains the detail stockholder records and handles the transfer of stock from one shareholder to another.  
c. The auditors typically confirm the following information with the stock registrar and transfer agent:  
• The number of shares issued.  
• The number of shares held in the company name, or the number of shares outstanding.

40. In the audit of interest-bearing debt auditors identify audit objectives and then determine appropriate audit procedures.   
a. List the audit objectives for substantive tests of interest-bearing debt.  
b. List seven substantive tests for interest-bearing debt to help the auditors meet the audit objectives.

a. The audit objectives for substantive tests of interest-bearing debt are:  
1. Use the understanding of the client and its environment to consider , including fraud risks, related to debt.  
2. Obtain an understanding of over owners' equity.  
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that  
a. Substantiate the of debt and the of the related transactions.  
b. Establish the of recorded debt.  
c. Verify the of transactions affecting debt.  
d. Determine that the client has to pay the recorded debt.  
e. Establish the proper of interest-bearing debt and the of transactions affecting debt.  
f. Determine that the and of interest-bearing debt are appropriate, including disclosure of the major provisions of loan agreements.  
b. Substantive tests for interest-bearing debt include (seven required):  
1. Obtain analyses of interest-bearing debt and related accounts.  
2. Examine copies of notes payable and supporting documents.  
3. Confirm interest-bearing debt.  
4. Vouch borrowing and repayment transactions.  
5. Perform analytical procedures.  
6. Test computations of interest expense, interest payable, and amortization of discount and premium.  
7. Evaluate whether debt provisions have been met.  
8. Verify authority for issuance of debt to corporate minutes.  
9. Review notes payable paid or renewed after the balance sheet date.  
10. Perform procedures to identify notes payable to related parties.  
11. Send confirmation letters about financing arrangements.  
12. Evaluate financial statement presentation and disclosure.