Chapter 22

Audit of the Capital Acquisition and Repayment Cycle

■ **Concept Checks**

P. 720

1. The characteristics of the liability accounts in the capital acquisition and repayment cycle that result in a different auditing approach than the approach followed in the audit of accounts payable are:
   - Relatively few transactions affect the account balance, but each transaction is often highly material in amount.
   - The exclusion of a single transaction could be material in itself.
   - There is a legal relationship between the client entity and the holder of the stock, bond, or similar ownership document.
   - There is a direct relationship between interest and dividend accounts and debt and equity.

2. The most important controls the auditor should be concerned about in the audit of notes payable are:
   - The proper authorization for the issuance of new notes (or renewals) to insure that the company is not being committed to debt arrangements that are not authorized.
   - Controls over the repayment of principal and interest to insure that the proper amounts are paid.
   - Proper records and procedures to insure that all amounts in all transactions are properly recorded.
   - Periodic independent verification to insure that all the controls over notes payable are working.

P. 727

1. The primary objectives in the audit of owners' equity accounts are to determine whether:

   a. The internal controls over capital stock and related dividends are adequate.

   b. Owners' equity transactions are recorded properly, as defined by the following six transaction-related audit objectives:
      - Occurrence
      - Completeness
      - Accuracy
      - Posting and summarization
      - Classification
      - Timing

Concept Check, P. 727 (continued)

c. Owners' equity balances in the financial statements satisfy the following balance-related audit objectives:

- Detail tie-in
- Existence
- Completeness
- Accuracy
- Classification
- Cutoff

d. Owners' equity balances are properly presented and disclosed to satisfy the following presentation and disclosure-related audit objectives:

- Occurrence and Rights and Obligations
- Completeness
- Accuracy and Valuation
- Classification and Understandability

2. The duties of a stock registrar are to make sure that stock is issued by a corporation in accordance with the capital authorization of the board of directors, to sign all newly issued stock certificates, and to make sure old certificates are received and cancelled before a replacement certificate is issued when there is a change in the ownership of the stock.

    The duties of a transfer agent are to maintain the stockholder records, and in some cases, disburse cash dividends to shareholders.

    The use of the services of a stock registrar improves the effectiveness of the client's internal controls by preventing the improper issuance of stock certificates. Along similar lines, the use of the services of an independent transfer agent improves the control over the stock records by putting them in the hands of an independent organization.

■ Review Questions

22-1 Four examples of interest bearing liability accounts commonly found on balance sheets are:

1. Notes payable
2. Contracts payable
3. Mortgages payable
4. Bonds payable

These liabilities have the following characteristics in common:

1. Relatively few transactions affect the account balance, but each transaction is often highly material in amount.
2. The exclusion of a single transaction could be material in itself.

22-1 (continued)

3. There is a legal relationship between the client entity and the holder of the stock, bond, or similar ownership document.
4. There is a direct relationship between interest and dividend accounts and debt and equity.

These liabilities differ in what they represent and the nature of their respective liabilities.

22-2 It is common to audit the balance in notes payable in conjunction with the audit of interest expense and interest payable because it minimizes the verification time and reduces the likelihood of overlooking misstatements in the balance. Once the auditor is satisfied with the balance in notes payable and the related interest rates and due dates for each note, it is easy to test the accuracy of accrued interest. If the interest expense for the year is also tested at the same time, the likelihood of omitting a note from notes payable for which interest has been paid is minimized. When there are a large number of notes or a large number of transactions during the year, it is usually too time consuming to completely tie out interest expense as a part of the audit of the notes payable and related accrued interest. Normally, however, there are only a few notes and few transactions during the year.

22-3 The most important analytical procedures used to verify notes payable is a test of interest expense. By the use of this test, auditors can uncover misstatements in interest calculations or possible unrecorded notes payable.

22-4 It is more important to search for unrecorded notes payable than unrecorded notes receivable because the omission of an asset is less likely to occur than the omission of a debt. Several audit procedures the auditor can use to uncover unrecorded notes payable are:

1. Examine the notes paid after year-end to determine whether they were liabilities at the balance sheet date.
2. Obtain a standard bank confirmation that includes specific reference to the existence of notes payable from all banks with which the client does business.
3. Review the bank reconciliation for new notes credited directly to the bank account by the bank.
4. Obtain confirmation from creditors who have held notes from the client in the past and are not currently included in the notes payable schedule.
5. Analyze interest expense to uncover a payment to a creditor who is not included on the notes payable schedule.
6. Review the minutes of the board of directors for authorized but unrecorded notes.

22-5 The primary purpose of analyzing interest expense is to uncover a payment to a creditor who is not included on the notes payable schedule. The primary considerations the auditor should keep in mind when doing the analysis are:

1. Is the payee for the interest payment listed in the cash disbursements journal also included in the notes payable list?
2. Has a confirmation for notes payable been received from the payee?

22-6 The tests of controls and substantive tests of transactions for liability accounts in the capital acquisition and repayment cycle consists of tests of the controls and substantive tests over the payment of principal and interest and the issuance of new notes or other liabilities, whereas the tests of details of balances concern the balance of the liabilities, interest payable, and interest expense. A unique aspect of the capital acquisition and repayment cycle is that auditors normally verify the transactions and balances in the account at the same time because of the limited number of transactions in the cycle.

22-7 Four types of restrictions long-term creditors often put on companies in granting them a loan are:

1. Financial ratio restrictions
2. Payment of dividends restrictions
3. Operations restrictions
4. Issue of additional debt restrictions

The auditor can find out about these restrictions by examining the loan agreement and related correspondence associated with the loan, and by confirmation. The auditor must perform calculations and observe activities to determine whether the client has observed the restrictions.

22-8 Although the corporate charter and bylaws are legal documents, their legal nature is not being judged by the auditor. They are being used only to reference transactions being tested by the auditor and provide insight into some of the key control features of the company. The auditor should consult an attorney if the information the auditor needs from the documents is not clear or if a legal interpretation is needed.

22-9 The major internal controls over owners' equity are:

1. Proper authorization of transactions
2. Proper record keeping
3. Adequate segregation of duties between maintaining owners' equity records and handling cash and stock certificates
4. The use of an independent registrar and stock transfer agent

22-10 The audit of owners' equity for a closely held corporation differs from that for a publicly held corporation in that the amount of time spent in verifying owners' equity in a closely held corporation is usually minimal because of the relatively few transactions for capital stock accounts that occur during the year. For publicly held corporations, the audit of owners' equity is more complex due to the existence of a larger number of shareholders and frequent changes in the individuals holding stock.

The audits are not significantly different in regard to whether the transactions in the equity accounts are properly authorized and recorded and whether the amounts in the accounts are properly classified, described, and stated in accordance with generally accepted accounting principles.

22-11 The number of shares outstanding, the correct valuation of capital stock transactions, and par value can all be confirmed with a transfer agent. The balance can then be easily recalculated from this information.

22-12 Because it is important to verify that properly authorized dividends have been paid to owners of stock as of the dividend record date, a comparison of a random sample of cancelled dividend checks to a dividend list prepared by management would be inadequate. Such an audit step is useless unless the dividend list has first been verified to include all stockholders of record at the dividend record date. A better test is to determine the total number of shares outstanding at the dividend date from the stock registrar and recompute the total dividends that should have been paid for comparison with the total amount actually paid. A random sample of payments should then be compared to the independent registrar's records to verify that the payments were actually made to valid shareholders.

22-13 If a transfer agent disburses dividends for a client, the total dividends declared can be verified by tracing the amount to a cash disbursement entry to the agent and also confirming the amount. There should ordinarily be no need to test individual dividend disbursement transactions if a stock transfer agent is used.

22-14 The major emphasis in auditing the retained earnings account should be on the recorded changes that have taken place during the year, such as net earnings for the year; dividends declared; prior period adjustments; extraordinary items charged or credited directly to retained earnings; or setting up or elimination of appropriations. Except for dividends declared, the other items should be verified during other parts of the engagement. This is especially true of the net earnings for the year. Therefore, the audit of retained earnings primarily consists of an analysis of the changes in retained earnings and the verification of the authorization and accuracy of the underlying transactions.

22-15 For auditing owners' equity and calculating earnings per share, it is crucial to verify that the number of shares used in each is accurate. Earnings are verified as an integral part of the entire audit and should require no additional verification as a part of owners' equity. The auditor should consider relevant accounting standards to verify that the earnings per share figure and the disclosures of descriptions of the various classes of stock noted in the corporate charter and minutes of the board of directors conform to those standards.

■ Multiple Choice Questions From CPA Examinations

22-16 a. (1) b. (2) c. (3)

22-17 a. (4) b. (1) c. (1)

■ Multiple Choice Questions From Becker CPA Exam Review

22-18 a. (3) b. (1) c. (3)

■ Discussion Questions and Problems

22-19

a. PURPOSE OF CONTROL	b. POTENTIAL FINANCIAL STATEMENT MISSTATEMENT	c. AUDIT PROCEDURE TO DETERMINE EXISTENCE OF MATERIAL MISSTATEMENT
1. To insure that all note liabilities are actual liabilities of the company.	Loss of assets through payment of excess interest rates or the diversion of cash to unauthorized persons.	Examine note request forms for proper authorization and discuss terms of note with appropriate management personnel.
2. To insure that notes are not paid more than once.	Loss of cash.	Examine outstanding notes and paid notes for similarities and the potential for reusing the notes.

22-19 (continued)

a. PURPOSE OF CONTROL	b. POTENTIAL FINANCIAL STATEMENT MISSTATEMENT	c. AUDIT PROCEDURE TO DETERMINE EXISTENCE OF MATERIAL MISSTATEMENT
3. To insure that notes payable transactions are recorded in full and in detail.	Improper disclosure or misstatements in notes payable through duplication.	Reconcile detailed contents of master file or other records to control account.
4. To insure that all note-related transactions agree with account balances.	Misstatement of notes payable.	Reconcile master file with outstanding notes payable.
5. To prevent misuse of notes and funds earmarked for notes.	Misstatement of liabilities and cash.	Perform all substantive procedures on extended basis. Trace from paid notes file to cash receipts to determine that the appropriate amount of cash was received when the note was issued.
6. To insure that only the proper interest amount is paid and recorded.	Misstatement of interest expense and related accrual.	Recompute interest on a test basis.

22-20 a.

AUDIT PROCEDURE	PURPOSE
1	To determine if the account balances are reasonable as related to each other and to examine for unreasonable changes in the account balances.
2	To obtain independent confirmation of bond indebtedness and collateral.
3	To determine the nature of restrictions on client as a means of verifying whether the restrictions have been met and to insure they are adequately disclosed.

22-20 (continued)

AUDIT PROCEDURE	PURPOSE
4	To insure that the bonds are not subject to unnecessary early retirement by bondholders and that proper disclosures are made.
5	To determine if the calculations are correct and accounts are accurate.

b. The auditor should be alert for the following provisions in the bond indenture agreement:

1. Restrictions on payment of dividends
2. Convertibility provisions
3. Provisions for repayment
4. Restrictions on additional borrowing
5. Required maintenance of specified financial ratios

c. The auditor can determine whether the above provisions have been met by the following procedures:

1. Audit of payments of dividends
2. Determine if the appropriate stock authorizations are adequate
3. Determine if sinking fund is adequate
4. Search for other liabilities
5. Calculate ratios and compare to agreement

d. The auditor should verify the unamortized bond discount or premium on a bond that was in force at the beginning of the year by recalculation. This is done by dividing the premium or discount by the number of total months the bonds will be outstanding and multiplying by the number of months remaining. For bonds issued in the current year, the bond premium or discount must first be verified. The monthly premium or discount is then calculated and multiplied by the number of months still outstanding.

e. The following information should be requested from the bondholder in the confirmation of bonds payable:

1. Amount of bond
2. Maturity date
3. Interest rate
4. Payment dates
5. Payment amounts
6. Assets pledged as security
7. Restrictions on client activities

22-21

AUDIT PROCEDURE	PRESENTATION AND DISCLOSURE-RELATED OBJECTIVE
1	Completeness
2	Classification and understandability
3	Accuracy and valuation
4	Occurrence and rights and obligations
5	Classification and understandability

22-22 a. The amounts listed for each type of long-term debt in the beginning balance column would be verified by examining the ending audited balances in the prior year audit files, in addition to the mathematical accuracy of the beginning balance column.

b. To obtain evidence about the items in the additions column, the auditor would obtain detailed information on individual additions comprising the additions amount for each account category and then examine supporting documentation, such as the long-term debt contracts and bond or debenture agreements, and the auditor would examine evidence of proper approval, such as minutes documenting board of director approval. The auditor would also verify whether cash was received and deposited in company cash accounts if the debt was tied to cash financing. For some types of long-term debt, such as a mortgage, the company would not receive cash given that the debt is linked to the purchase of an asset. Thus, the auditor would verify that the acquired property is included as an addition in the audit schedule reflecting property, plant, and equipment or other asset account.

c. To obtain evidence about the items in the payments column, the auditor would review the related debt contract to determine if the amounts paid are reasonable. The auditor would also verify that the payment amounts agree with cash disbursement records and associated bank statements. The auditor may consider confirming the payment information with the bond trustee.

d. The auditor would verify the mathematical accuracy of the summation of the beginning balances plus additions less payments to ensure it crossfoots to the ending balance for each long-term debt category listed on the schedule. The auditor would also recalculate the summation of the amounts listed in the ending balance column to the total shown on the schedule. Each ending balance would be tied to the general ledger balances and the total would be traced to the line item in the balance sheet. The auditor may also confirm the ending balance with the noteholder.

22-22 (continued)

e. The auditor would verify interest rates and due dates by examining the long-term debt contracts, such as the bond or debenture agreement.

f. The auditor could use the information in the schedule to develop a substantive analytical procedure related to interest expense. The auditor could calculate an average long-term debt balance for each type of debt listed on the schedule that would be multiplied by that debt's interest rate to develop an expectation of interest expense for each debt category. The auditor would then compare the summation of those expectations for all debt types to the recorded interest expense in the general ledger.

To audit interest payable, the auditor would verify, by review of the debt agreements, the interest payment due dates and interest rates to determine the appropriate period of time for which interest expense requires accrual. For example, the debt agreement for the convertible debentures may indicate that interest is due quarterly on the first day of April, July, October, and January. Thus, the auditor would expect that that one quarter's interest expense ($131,250) requires accrual as of December 31, 2016 ($10,000,000 times 5.25% divided by 4 = $131,250). That expectation would be compared to the amount recorded in the general ledger as accrued interest for that debt type. The auditor would also need to determine that prior interest payments have been made and recorded, thus not requiring any additional accrual at December 31.

22-23 a. The emphasis in the verification of notes payable in this situation should be in determining whether all existing notes are included in the client's records. The four audit procedures listed do not satisfy this emphasis.

b.

AUDIT PROCEDURE	PURPOSE
1	To determine if the notes payable list reconciles to the general ledger.
2	To determine if the notes payable on the list are correctly recorded and disclosed.
3	To verify that all recorded notes payable are properly recorded and disclosed.
4	To insure that interest expense is properly recorded on the books.

22-23 (continued)

c. Procedure 2 is not necessary in light of procedure 3. They both perform the same function and the confirmation is from an independent source. The sample sizes for the procedures are probably appropriate, considering the deficiencies in record keeping procedures.

d. In addition to the procedures mentioned, the following tests are essential because there must be a search for unrecorded notes:

1. Analyze interest expense and send a confirmation for notes payable to all payees not receiving a confirmation for notes.
2. Confirm the balance in notes payable to payees included in last year's notes payable list but not confirmed in the current year.
3. Examine notes paid after year-end to determine whether they were liabilities at the balance sheet date.
4. Obtain a standard bank confirmation that includes a specific reference to notes payable from all banks with which the client does business.
5. Review the minutes of the board of directors.

22-24 In each case, any actual failure to comply would have to be reported in a footnote to the statements in view of the possible serious consequences of advancing the maturity date of the loan. The individual audit steps that should be taken are as follows:

a. Calculate the working capital ratio at the beginning of and through the previous fiscal year. If it is under 2 to 1, determine compensation of officers for compliance with the limitation.

b. Examine the client's copies of insurance policies or certificates of insurance for compliance with the covenant, preparing a schedule of book value, appraised or estimated value, and coverage for the report. Confirm policies held with trustee.

c. Examine vouchers supporting tax payments on all property covered by the indenture. By reference to the local tax laws and the vouchers, determine that all taxes have been paid before the penalty-free period expired. If the vouchers in any case are inadequate, confirm with the trustee who holds the tax receipts.

d. Vouch the payments to the sinking fund. Confirm bond purchases and sinking fund balance with trustee. Observe evidence of destruction of bonds for bonds cancelled. Report the fund as an asset, preferably giving the composition as to cash and bonds held alive, if any.

22-25 a. It is desirable to prepare an audit schedule for the permanent file for the mortgage so that the appropriate information concerning the mortgage will be conveniently available for future years' audits. This information should include all the provisions of the mortgage as well as the purchase price, date of purchase, and a list of items pledged as collateral. It may also contain an amortization schedule of principal and interest.

b. The audit of mortgage payable, interest expense, and interest payable should all be done together since these accounts are related and the results of testing each account have a bearing on the other accounts. The likelihood of misstatement in the client's records is determined faster and more effectively by doing them together.

c. The audit procedures that should ordinarily be performed to verify the issue of the mortgage, the balance in the mortgage and interest payable, and the balance in the interest expense accounts are:

1. Determine if the mortgage was properly authorized.
2. Obtain the mortgage agreement and schedule the pertinent provisions in the permanent file, including the face amount, payments, interest rate, restrictions, and collateral.
3. Confirm the mortgage amount, terms, and collateral with the lending institution.
4. Recompute interest payable at the balance sheet date and reconcile interest expense to the decrease in principal and the payments made.
5. Test interest expense for reasonableness.

d. Accounting standards require disclosures related to long-term debt. The terms of the debt agreement are to be disclosed, including interest rates, maturity dates, five-year payment information, assets pledged as collateral, among other items. Significant restrictions on the activities of the company, such as maintaining cash or other compensating balances or restricting the amount of dividends that can be paid, should be disclosed. Thus, auditors obtain copies of long-term debt agreements to determine that the client's disclosures are complete and accurate.

22-26

a. PURPOSE OF CONTROL	b. POTENTIAL FINANCIAL STATEMENT MISSTATEMENT	c. AUDIT PROCEDURES TO DETERMINE EXISTENCE OF MATERIAL MISSTATEMENT
1. To insure that all shares issued or retired are properly authorized.	Misstatement of dividends declared on balance sheet or payment to the wrong people, which could result in a liability.	Verify authenticity of all changes in owners' equity account.
2. To insure that stock is issued and retired only at the discretion of the board.	Illegal payments of cash and issue of shares.	Examine cancelled shares and newly issued ones to make sure they are included in the board of directors' minutes.
3. To insure that records are properly maintained.	Misstatement of owners' equity and the disbursement of dividends and capital to the wrong people.	Determine if company uses services of an independent registrar, or transfer agent. Confirm details of equity accounts with them.
4. To insure that records are properly maintained.	Misstatement of owners' equity and earnings per share.	Account for all unissued certificates and account for all cancelled certificates and their mutilation.
5. To insure that the general ledger reflects the balance of supporting records.	Misstatement of owners' equity and earnings per share.	Trace postings from master file and stock certificates into general ledger. Reconcile master file to general ledger.
6. To insure that the dividends declared are paid to the proper individuals.	Misstatement of dividends declared on balance sheet or payment to the wrong people, which could result in a liability.	Obtain confirmation of paid dividends from independent transfer agent.

22-27 a. The number of shares and dollar amounts listed as the balances as of September 28, 2013, would be verified by examining the ending audited balances in the prior year audit files, in addition to the mathematical accuracy of the beginning balance column.

22-27 (continued)

b. To obtain evidence about the amount shown as Net Income, the auditor would simply trace the entry in retained earnings to theearnings figure on the income statement. This procedure generally takes place near the end of the audit in case adjusting entries affecting net earnings are required.

c. The audit procedures that should ordinarily be performed to verify the repurchase of common stock, share-based compensation, and common shares issued are described below:

1. *Repurchase of common stock:* The auditor would examine minutes of meetings of the board of directors that document the approval of the decision to repurchase the shares, including the amount of shares authorized for repurchase. The auditor would also examine the cash disbursements journal and related documentation that supports the disbursement of cash for the repurchase transaction for occurrence and accuracy of the amounts shown.
2. *Share-based compensation:* The auditor would examine documents that outline the terms of the compensation plans, which may include examination of shareholder proxy proposals related to compensation voted on by shareholders and it may include review of minutes of meetings of the board of directors or its compensation committee for evidence of approval of the compensation plan terms. The auditor would evaluate whether the amounts reflected as share-based compensation are consistent with terms of the compensation plan. The auditor may also confirm terms of the transactions with the stock transfer agent.
3. *Common shares issued:* The auditor would examine minutes of meetings of the board of directors that document the approval of the decision to issue common shares, including the amount of issuance approved. The auditor may also confirm terms of the share issuance transactions with the stock transfer agent.

d. The amounts shown as of September 27, 2014, in the Statement of Shareholders' Equity should also be included as ending balances in the shareholders' equity section of the Balance Sheet as of September 27, 2014. The auditor would determine that those amounts agree between each of these two financial statements.

22-28

a. PURPOSE OF AUDIT PROCEDURES	b. MISSTATEMENTS THAT MAY BE UNCOVERED
1. To determine what type of stock may be issued, under what circumstances, and its description.	Unauthorized outstanding stock or improper description of stock.
2. To determine the propriety of changes in the accounts and to verify their accuracy.	The issuance or retirement of stock without proper authorization, improper valuation, or incorrect dividend calculations.
3. To determine if there were any shares issued or retired during year, or if any certificates are missing.	Unrecorded or unauthorized transactions, or transactions not handled in a legal manner.
4. To determine if all retired stock has been cancelled.	Same as 3.
5. To determine if any stock issues, retirements, or dividends were authorized.	Unauthorized or omitted equity transactions.
6. To verify that earnings per share has been correctly computed.	Incorrect earnings per share computation.
7. To determine that dividends are legal and disclosure in the financial statements is proper.	Illegal payments of dividends and improper disclosure of the information in the financial statements.

22-29 a. The audit program for the audit of Pate Corporation's capital stock account would include the following procedures:

1. Examine the articles of incorporation, the bylaws, and the minutes of the board of directors from the inception of the corporation to determine the provisions or decisions regarding the capital stock, such as classes of stock, par value or stated value, authorized number of shares, authorization for the sale of new issues or additional sales of unissued stock, declarations of stock splits and dividends in the form of cash or stock, and granting of stock options or stock rights. Determine that the accounting records are in accordance with these provisions or decisions and that appropriate disclosure is made by footnote if necessary. Extract pertinent data for the auditor's permanent file.

22-29 (continued)

2. Examine the stock certificate stub book and determine whether the total of the open stubs agrees with the Capital Stock account in the general ledger. Examine cancelled stock certificates, which are generally attached to the corresponding stub.

   Information on the stubs regarding the number of shares, date, etc. for both outstanding and cancelled stock certificates should be compared with the Capital Stock account. All certificate numbers should be accounted for and, if the CPA deems it necessary, confirmation of the number of certificates printed should be obtained from the printer. A test check should be made to determine that the proper amounts of original issue and capital stock transfer taxes have been affixed to the stubs and the cancelled certificates. The stockholders shown in the stock certificate stub book should be compared with the stockholders' master file if one is maintained.

3. Analyze the capital stock account from the corporation's inception and verify all entries. Trace all transactions involving the transfer of cash either to the cash receipts or the cash disbursements records. If property other than cash was received in exchange for capital stock, trace the recording of the property to the proper asset account and consider the reasonableness of the valuation placed on the property.

   Transactions showing the sale of stock at a discount or premium should be traced to the capital contributed in excess of par value account. If capital stock has been sold at a discount, consideration should be given to the possible violation of state laws and the client's attention should be directed to the matter. Should the analysis of the capital stock account disclose that the corporation has engaged in treasury stock transactions, determine that the increase or decrease in net assets resulting from these transactions has not been placed in the retained earnings account.

   The audit procedures to be applied to the audit of the capital contributed in excess of par value account are usually applied at the same time that the capital stock account is being audited because the two accounts are interrelated. The accounts should be analyzed and the entries verified when the related entries in the capital stock account are verified. If an entry is not related to capital stock account entries, as in the case of a write-off of a deficit as the result of a quasi-reorganization, authorization for the entry and the supporting material should be examined.

22-29 (continued)

4. The following audit procedures would be applied to the retained earnings account:

   i. Analyze the account from its inception. Consider the validity of the amounts representing income or loss that were closed from the profit and loss account. Amounts representing appraisal increments or writing up of assets should be considered for reasonableness, and the increase should be reported separately from retained earnings in the stockholders' equity section of the balance sheet.

   ii. Any extraordinary gains or losses carried directly to the retained earnings account should be investigated and their treatment reviewed in relation to accounting standards.

   iii. Entries recording the appropriation of retained earnings or the return of such appropriations should be reviewed for reasonableness, and authorization for the entries should be traced to the proper authority. Similarly, actions of the board of directors that affected retained earnings should be traced to the account analysis.

   iv. Conditions such as loan covenants or contingent liabilities that were uncovered during the audit that might require or make desirable the placing of restrictions on retained earnings should be reviewed for proper disclosure in the financial statements.

   v. Entries recording cash or stock dividends should be traced to the minutes of the board of directors for authorization and traced to the cash account or the capital stock account. A separate computation should be made by the CPA of the total amount of dividends paid based upon his or her schedules of outstanding stock as an overall test of the existence of the distributions. If stock dividends have been distributed, the amount removed from retained earnings should be reviewed for compliance with accounting standards.

b. In conducting his or her audit, the CPA verifies retained earnings as he or she does other items on the balance sheet for several reasons. A principal reason is that the verification is an assurance or double check that no important item was overlooked in the audit of the accounts that were the contra or balancing part of the entry recorded in retained earnings.

22-29 (continued)

An example of an important item that may be overlooked would be a balance sheet account that was closed during the year under audit and the account removed from the general ledger current file. Another reason is that, though the entry in the contra account may have been examined, the auditor may have overlooked that the balancing part of the entry was to retained earnings, a treatment that may have been contrary to accounting standards; his or her audit of retained earnings would bring this noncompliance to his or her attention.

Still another reason for verifying the retained earnings account is to determine whether any portion of the balance in the account may be subject to restriction by state law or other authority. Since the account is the basis for the payment of dividends, it is important to determine that the balance is composed of income realized from transactions free from any restrictions.

22-30 a.

ACCOUNT	EXPECTED CHANGE IN BALANCE 2014 TO 2015	EXPLANATION FOR EXPECTED CHANGE IN BALANCE
Cash	Increase	While much of the proceeds were used to reduce debt and purchase hardware and software, unused proceeds were deposited in company bank accounts.
Accounts Receivable	Little Change	The process of becoming publicly held would likely have minimal impact on accounts receivable, unless the volume of business on the E-Antiques Web site significantly grows as a result of going public.
Property, Plant, and Equipment	Increase	Because stock proceeds were used to purchase hardware and software, the balance in property, plant, and equipment would be expected to increase.
Accounts Payable	Increase	Assuming the purchase of hardware and software is made on account, the balance in accounts payable would be expected to increase.
Long-Term Debt	Decrease	Because stock proceeds were used to pay off loans, the balance in long-term debt would be expected to decrease.

22-30 (continued)

ACCOUNT	EXPECTED CHANGE IN BALANCE 2014 TO 2015	EXPLANATION FOR EXPECTED CHANGE IN BALANCE
Common Stock	Increase	Despite using stock proceeds to acquire original shares from company founders, the issuance of stock through the process of going public would result in a significant increase in the common stock account.
Additional Paid-in Capital	Increase	Despite using stock proceeds to acquire original shares from company founders, the issuance of stock through the process of going public would result in a significant increase in the additional paid in capital account, assuming the stock was issued at a price above par value.
Retained Earnings	No Change	The transactions associated with going public would not affect the retained earnings account.
Treasury Stock	Increase	The acquisition of the original shares from the company founders would be treated as a purchase of treasury stock, thereby increasing the account balance.
Dividends	No Change	The transactions associated with going public would not directly affect the dividends account. If the company pays dividends, the account would increase because of the increase in the number of shares outstanding.
Revenues	Little Change	The process of becoming publicly held would likely have minimal impact on revenues for the current year, unless the volume of business on the E-Antiques Web site significantly grows as a result.

b. While the decline in stock market price to $19 per share is not favorable news for E-Antiques, that decline would have no impact on the common stock, additional paid-in capital, or retained earnings accounts since the company did not engage in any stock related transactions during 2016. Rather, the decline in market value impacts E-Antiques investors.

c. The decline in stock price would likely increase the auditor's assessment of business risk and audit risk. The decline is likely to place significant pressure on management to generate favorable financial results in order to boost stock prices to earlier highs.

22-30 (continued)

That pressure may create a strong enough incentive for management to engage in activities that may lead to an increased likelihood of material misstatements in the financial statements due to fraud.

22-31 a. The three distinct tiers of the NASDAQ market are The NASDAQ Global Select Market®, The NASDAQ Global Market®, and The NASDAQ Capital Market®. The NASDAQ Global Select Market® has the most stringent listing requirements.

b. The NASDAQ Global Select Market® requires a minimum of 1,250,000 publicly held shares.

c. The four standards for the NASDAQ Global Market® are:

1. Income Standard
2. Equity Standard
3. Market Value Standard
4. Total Assets/Total Revenue Standard

The standards require a minimum bid price of $4 and minimum of 400 round lot shareholders.

d. Securities issuances that require shareholder approval include:

- Acquisitions where the issuance equals 20% or more of the pre-transaction outstanding shares (or 5% or more of the pre-transaction outstanding shares when a related party has a 5% or greater interest in the acquisition target).
- Issuances that results in a change in control.
- Issuances involving equity compensation.
- Private placements where the issuance equals 20% or more of the pre-transaction outstanding shares at a price less than the greater of book or market value.