**CHAPTER 7**

**AUDIT OF EQUITY CAPITAL**

Equity consists of share capital and reserves. This part of the balance sheet represents interest of the owners in net assets of the entity.

To verify the owners’ equity the auditor verifies the following aspects:

􀂃 Share capital is properly classified and described in the accounts

􀂃 Movement in share capital is properly authorized and correctly presented

􀂃 Reserves are properly classified and presented

􀂃 Movements in reserves are properly authorized

**Verification Methods**

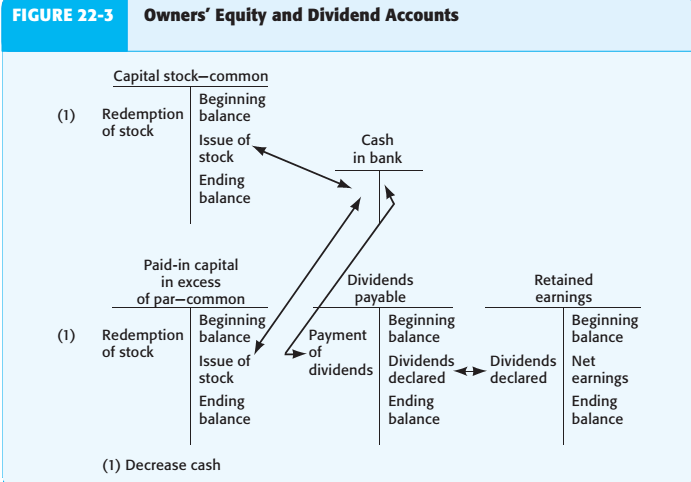
For publicly held corporations, the verification of owners’ equity is more complex because of the larger numbers of shareholders and frequent changes in the individuals holding the stock.

The rest of this chapter deals with tests for verifying the major owners’ equity accounts in a publicly held corporation, including:

* Capital stock
* Paid-in capital in excess of par
* Retained earnings and related dividends

Figure 22-3 (p. 719) provides an overview of the specific owners’ equity accounts discussed. The objective for each is to determine whether:

* + Internal controls over capital stock and related dividends are adequate
  + Owners’ equity transactions are correctly recorded,
  + Owners’ equity balances are properly recorded,



**Internal Controls**

Several internal controls are important for owners’ equity activities as follows

1. **Proper Authorization of Transactions*-*** Because each owner’s equity transaction is typically material, many of these transactions must be approved by the board of directors. The following types of owners’ equity transactions usually require specific authorization:

• ***Issuance of Capital Stock***. The authorization includes the type of equity to issue (such as preferred or common stock), number of shares to issue, par value of the stock, privileged condition for any stock other than common, and date of the issue.

• ***Repurchase of Capital Stock.*** The repurchase of common or preferred shares, the timing of the repurchase, and the amount to pay for the shares should all be approved by the board of directors.

• ***Declaration of Dividends.*** The board of directors must authorize the form of the dividends (such as cash or stock), the amount of the dividend per share, and the record and payment dates of the dividends.

1. **Proper Record Keeping and Segregation of Duties** - When a company maintains its own records of stock transactions and outstanding stock, the internal controls must be adequate to ensure that:

• Actual owners of the stock are recognized in the corporate records

• The correct amount of dividends is paid to the stockholders owning the stock as of the dividend record date

• The potential for misappropriation of assets is minimized

The proper assignment of personnel, adequate record-keeping procedures, and independent internal verification of information in the records are useful controls for these purposes. The client should also have well-defined policies for preparing stock certificates and for recording capital stock transactions.

When issuing and recording capital stock, the client must comply with both the state laws governing corporations and the requirements in the corporate charter. The par value of the stock, the number of shares the company is authorized to issue, and state taxes on the issue of capital stock all affect issuance and recording.

As a control over capital stock, most companies maintain stock certificate books and a shareholders’ capital stock master file. A capital stock certificate record records the issuance and repurchase of capital stock for the life of the corporation. The record for a capital stock transaction includes the certificate number, the number of shares issued, the name of the person to whom it was issued, and the issue date. When shares are repurchased, the capital stock certificate book should include the cancelled certificates and the date of their cancellation.

A shareholders’ capital stock master file is the record of the outstanding shares at any given time. The master file acts as a check on the accuracy of the capital stock certificate record and the common stock balance in the general ledger. It is also used as the basis for the payment of dividends.

1. **Independent Registrar and Stock Transfer Agent** -Any company with stock listed on a securities exchange is required to engage an independent registrar as a control to prevent the improper issue of stock certificates. The responsibility of an independent registrar is to make sure that stock is issued by a corporation in accordance with the capital stock provisions in the corporate charter and the authorization of the board of directors. When there is a change in the ownership of the stock, the registrar is responsible for signing all newly issued stock certificates and making sure that old certificates are received and cancelled before a replacement certificate is issued.

Most large corporations also employ the services of a stock transfer agent to maintain the stockholder records, including those documenting transfers of stock ownership.

The employment of a transfer agent helps strengthen control over the stock records by putting the records in the hands of an independent organization and helps reduce the cost of record keeping by using a specialist.

**Audit of Capital Stock and Paid-in Capital**

Auditors have four main concerns in auditing capital stock and paid-in capital in excess of par:

1. *Existing capital stock transactions are recorded (completeness transaction-related objective*).

This objective is easily satisfied when a registrar or transfer agent is used. The auditor can confirm with them whether any capital stock transactions occurred and the accuracy of existing transactions and then determine if all of those transactions have been recorded. To uncover issuances and repurchases of capital stock, auditors also review the minutes of the board of directors meetings, especially near the balance sheet date, and examine client-held stock record books.

1. *Recorded capital stock transactions occurred and are accurately recorded (occurrence and accuracy transaction-related objectives).*

Extensive auditing is required for transactions involving issuance of capital stock such as the issuance of new capital stock for cash, the merger with another company through an exchange of stock, donated shares, and the purchase of treasury shares. Regardless of the controls, it is normal practice for auditors to verify all capital stock transactions because of their materiality and permanence in the records. The occurrence transaction-related objective can ordinarily be tested by examining the minutes of the board of directors meetings for proper authorization.

Auditors can readily verify accurate recording of capital stock transactions for cash by confirming the amount with the transfer agent and tracing the amount of the recorded capital stock transactions to cash receipts. (In the case of treasury stock, the amounts are traced to the cash disbursements journal.) In addition, the auditor must verify whether the correct amounts were credited to capital stock and paid-in capital in excess of par by referring to the corporate charter to determine the par or stated value of the capital stock.

1. *Capital stock is accurately recorded (accuracy balance-related objectives).*

Auditors verify the ending balance in the capital stock account by first determining the number of shares outstanding at the balance sheet date. A confirmation from the transfer agent is the simplest way to obtain this information. When no transfer agent exists, the auditor must rely on examining the stock records and accounting for all shares outstanding in the stock certificate records, examining all cancelled certificates, and accounting for blank certificates.

After the auditor is satisfied that the number of shares outstanding is correct, the recorded par value in the capital account can be verified by multiplying the number of shares by the par value of the stock. The ending balance in the capital in excess of par account is a residual amount. It is audited by verifying the amount of recorded transactions during the year and adding them to or subtracting them from the beginning balance in the account.

A major consideration when auditing the accuracy balance-related objective for capital stock is verifying whether the number of shares used in the calculation of earnings per share is accurate. It is easy to determine the correct number of shares to use in the calculation when there is only one class of stock and a small number of capital stock transactions. The problem becomes much more complex when there are convertible securities, stock options, or stock warrants outstanding. Auditors must have thorough understanding of requirements of relevant accounting standards before verifying the number of shares for determining basic and diluted earnings per share.

1. *Capital stock is properly presented and disclosed (all presentation and disclosure objectives).*

The most important sources of information for determining whether all four presentation and disclosure-related objectives for capital stock activities are satisfied are the corporate charter, the minutes of board of directors meetings, and the auditor’s analysis of capital stock transactions.

The auditor should determine that each class of stock has a proper description, including the number of shares issued and outstanding and any special rights of an individual class. Auditors should also verify the proper presentation and disclosure of stock options, stock warrants, and convertible securities by examining legal documents or other evidence of the provisions of these agreements.

**Audit of Dividends**

The emphasis in the audit of dividends is on dividend transactions rather than on the ending balance. The exception is when there are dividends payable.

All six transaction-related audit objectives for transactions are relevant for dividends. But typically, dividends are audited on a 100 percent basis. The most important objectives, including those concerning dividends payable, are:

1. Recorded dividends occurred (occurrence).

2. Existing dividends are recorded (completeness).

3. Dividends are accurately recorded (accuracy).

4. Dividends are paid to stockholders that exist (occurrence).

5. Dividends payable are recorded (completeness).

6. Dividends payable are accurately recorded (accuracy).

Auditors can verify the occurrence of recorded dividends by examining the minutes of board of directors meetings for authorization of the amount of the dividend per share and the dividend date. When doing so, the auditor should be alert to the possibility of unrecorded dividends declared, particularly shortly before the balance sheet date. A closely related audit procedure is to review the audit permanent file to determine whether restrictions exist on the payment of dividends in bond indenture agreements or preferred stock provisions.

The accuracy of a dividend declaration can be audited by recalculating the amount on the basis of the dividend per share times the number of shares outstanding. If the client uses a transfer agent to disburse dividends, the total can be traced to a cash disbursement entry to the agent and also confirmed.

When a client keeps its own dividend records and pays the dividends itself, the auditor can verify the total amount of the dividend by recalculation and reference to cash disbursed. In addition, auditors must verify whether the payment was made to the stockholders who owned the stock as of the dividend record date. They can test this by selecting a sample of recorded dividend payments and tracing the payee’s name on the cancelled check to the dividend records. At the same time, auditors can verify the amount and the authenticity of the dividend check.

Tests of dividends payable should be done in conjunction with declared dividends.

Any unpaid dividend should be included as a liability.

**Audit of Retained Earnings**

For most companies, the only transactions involving retained earnings are net earnings for the year and dividends declared. Other changes in retained earnings may include corrections of prior-period earnings, prior-period adjustments charged or credited directly to retained earnings, and the setting up or elimination of appropriations of retained earnings.

To begin the audit of retained earnings, auditors first analyze retained earnings for the entire year. The audit schedule showing the analysis, which is usually a part of the permanent file, includes a description of every transaction affecting the account.

To accomplish the audit of the credit to retained earnings for net income for the year (or the debit for a loss) auditors simply trace the entry in retained earnings to the net earnings figure on the income statement. This procedure must, of course, take place fairly late in the audit after all adjusting entries affecting net earnings have been completed.

In auditing debits and credits to retained earnings, other than net earnings and dividends, auditors must determine whether the transactions should have been included.

For example, prior-period adjustments can be included in retained earnings only if they satisfy the requirements of accounting standards.

After the auditor is satisfied that the recorded transactions were correctly classified as retained earnings transactions, the next step is to decide whether they were accurately recorded. The audit evidence necessary to determine accuracy depends on the nature of the transactions. For example, if an appropriation of retained earnings is required for a bond sinking fund, auditors can determine the correct amount of the appropriation by examining the bond indenture agreement. If there is a major loss charged to retained earnings because of a material nonrecurring abandonment of a plant, the evidence needed to determine the amount of the loss can be complex and include examining a large number of documents and records, as well as discussions with management.

Auditors must also evaluate whether any transactions should have been included but were not. For example, if the client declared a stock dividend, the market value of the securities issued should be capitalized by a debit to retained earnings and a credit to capital stock. Similarly, if the financial statements include appropriations of retained earnings, the auditor should evaluate whether it is still necessary to have the appropriation as of the balance sheet date.

Accounting standards require presentation and disclosure of information related to retained earnings. The auditor’s primary concern in determining whether presentation and disclosure objectives for retained earnings are satisfied primarily relates to disclosure of any restrictions on the payment of dividends. Often, agreements with bankers, stock -holders, and other creditors prohibit or limit the amount of dividends the client can pay. These restrictions must be disclosed in the footnotes to the financial statements.