

CHAPTER 11

The Why and How of Auditing Debt

What are the keys to auditing debt?

While auditing debt can be simple, sometimes it's tricky. For instance, classification issues can arise when debt covenant violations occur. Should the debt be classified as current or noncurrent? Likewise, some forms of debt (with detachable warrants) have equity characteristics, again leading to classification issues. Is it debt or equity—or both? Additionally, leases can create debt, even if that is not the intent.

Most of the time, however, auditing debt is simple. A company borrows money. An amortization schedule is created. And thereafter, debt service payments are made and recorded.

Either way, whether the process is complicated or simple, below I show you how to audit debt.

Auditing Debt — An Overview

In many governments, nonprofits, and small businesses, debt is a significant portion of total liabilities. Consequently, it is often a significant transaction area.

In this chapter, we will cover the following:

- Primary debt assertions
- Debt walkthroughs
- Directional risk for debt
- Primary risks for debt

- Common debt control deficiencies
- Risk of material misstatement for debt
- Substantive procedures for debt
- Common debt work papers

Primary Debt Assertions

First, let's look at assertions. The primary relevant debt assertions include completeness, classification, and obligation.

I believe, in general, completeness and classification are the most important debt assertions. When a company shows debt on its balance sheet, it is asserting that it is complete and classified correctly. By classification, I mean it is properly displayed as either short-term or long-term. I also mean the instrument is debt and recorded as such (and not equity). In regard to the obligation assertion, the company is asserting that the debt is owed by the company and not another entity.

Debt Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions.

As you perform your debt walkthrough, ask questions or perform actions such as the following:

- Are there any debt covenant violations?
- If the company has violations, is the debt classified appropriately (usually current)?
- Is someone reconciling the debt in the general ledger to a loan amortization schedule?
- Inspect amortization schedules.
- Does the company have any unused lines of credit or other credit available?
- Inspect loan documents.

- Has the company refinanced its debt with another institution? Why?
- Who approves the borrowing of new money?
- Who approves new leases? Who handles lease accounting and are they competent?
- Does the company have any leases that should be recorded as debt?
- Inspect new loan and lease approvals.
- How are debt service payments made (e.g., by check or wire)? Who makes those payments?
- Are there any sinking funds? If yes, who is responsible for making deposits and payments?
- Observe the segregation of duties for persons:
 - Approving new loans
 - Receipting loan proceeds
 - Recording debt in the general ledger
 - Reconciling the debt in the general ledger to the loan amortization schedules
- Is the company required to file periodic reports with the lender? Inspect sample debt-related reports, if applicable.
- Does the company have any convertible debt or debt with detachable warrants? Are they properly recorded?
- Is the company following reporting framework requirements (e.g., FASB Codification) for debt?
- Is collateral pledged? If yes, what?
- What are the terms of the debt agreements?
- Is all debt recorded in the general ledger?
- Are debt issuance costs accounted for properly?
- Has the company guaranteed the debt of another entity?
- Are there standby letters of credit?

If control weaknesses exist, create audit procedures to address them. For example, if—during the walkthrough—we see that one person approves loans, deposits loan proceeds, and records

the related debt, then we will perform fraud-related substantive procedures.

A company can fraudulently inflate its equity by intentionally omitting debt from its balance sheet. (Total assets equal liabilities plus equity. Therefore, if debt decreases, equity increases.)

As we saw with Enron, some entities place their debt on another company's balance sheet. (Enron did so using special purpose entities.) So, auditors need to consider that companies can intentionally omit debt from their balance sheets.

Another potential fraudulent presentation is showing short-term debt as long-term. When might this happen? When debt covenant violations occur. Such violations can trigger a requirement to reclassify long-term debt to short-term. If accounting personnel are aware of the requirement to classify debt as current and don't do so, then the reporting could be considered fraudulent.

Additionally, mistakes can lead to errors in debt accounting. Errors in accounting for debt can occur when principal payments are misclassified as expenses rather than debt reduction. Also, debt can erroneously be presented as long-term when it is current. Why? Maybe the company's accountant is not aware of the accounting rules. Also, some forms of debt, such as leases, can be difficult to interpret. Consequently, a company might errantly fail to record debt when required.

Directional Risk for Debt

Third, consider the directional risk of debt.

The directional risk for debt is that it is understated. Thus, make sure you audit for completeness and determine that all debt is recorded.

Primary Risks for Debt

Fourth, think about the risk related to debt. Primary risks for debt include:

- Debt is intentionally understated or omitted
- Debt is shown as noncurrent (due *more than* one year from the balance sheet date) though the amount is due *within* one year of the balance sheet date
- Leases are not recorded as debt though the reporting framework requires such accounting

It's obvious why a company might want to understate its debt. The company looks healthier. But why would a business desire to classify current debt as noncurrent? For the same reason: to make the company look stronger. By recording current debt as noncurrent, the company's working capital ratio (current assets divided by current liabilities) improves.

Common Debt Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment procedures.

In smaller entities, it is common to have the following control deficiencies:

- One person performs two or more of the following:
 - Approves new loans
 - Has the ability to borrow funds
 - Enters new debt in the accounting system
 - Deposits funds from the debt issuance
- Funds are borrowed without appropriate approval
- Debt postings are not agreed to amortization schedules
- Accounting personnel don't understand the accounting standards for debt (including lease accounting)

Risk of Material Misstatement for Debt

Sixth, assess your risk of material misstatement in light of the information you've gathered.

In auditing debt, the assertions that concern me the most are completeness, classification, and obligation. So the risk of material misstatement for these assertions is usually moderate to high.

My response to the higher risk assessments is to perform certain substantive procedures: namely, a review of debt covenant compliance and a review of debt and lease agreements—and the related accounting. Why?

As we saw above, debt covenant violations may require the company to reclassify debt from noncurrent to current. Doing so can be significant. The loan could be called by the lender, depending on the loan agreement. Proper classification of debt is critical.

Also, some leases should be recorded as debt. If such leases are not recorded, the company looks healthier than it is. Our audits should include procedures that address the completeness of debt and the obligations of the company.

Substantive Procedures for Debt

And finally, it's time to determine your substantive procedures in light of your identified risks.

My customary tests for auditing debt are as follows:

- Summarize and test debt covenants
- Review new leases to determine if debt should be recorded
- Confirm all significant debt with lenders
- Determine if all debt is classified appropriately
(as current or noncurrent)
- Agree the end-of-period balances in the general ledger to the amortization schedules

- Agree future debt service payment summaries to amortization schedules
- Review accruals of any significant interest
- Review interest expense (usually comparing current and prior year)

I don't normally test controls related to debt. If controls are tested and you determine they are effective, then some of the substantive procedures listed above may not be necessary.

Common Debt Work Papers

My debt work papers normally include the following:

- An understanding of debt-related internal controls
- Documentation of any internal control deficiencies related to debt
- Risk assessment of debt at the assertion level
- Debt audit program
- A copy of all significant debt agreements (including lease and line-of-credit agreements)
- Minutes reflecting the approval of new debt
- A summary of debt activity (beginning balance plus new debt minus principal payments and ending balance)
- Amortization schedules for each debt
- Summary of all debt information for disclosure purposes (e.g., future debt service to be paid, interest rates, types of debt, collateral, etc.)
- Disclosure checklist

If there are questions regarding debt agreements and their presentation, I include additional language in the representation letter to address the issues. For example, if an owner loans funds to the company but there is no written debt agreement, the owner or management might verbally explain the arrangement. In such cases, I include language in the management representation letter to address the verbal assertions.

Auditing Debt - A Simple Summary

- Primary relevant debt assertions include completeness, classification, and obligation
- Perform a walkthrough of the debt cycle by making inquiries, inspecting documents, and making observations
- The directional risk for debt is that it is understated
- Primary risks for debt include:
 - Debt is intentionally understated or omitted
 - Debt is classified as noncurrent though it is current
 - Leases are not recorded as debt though the reporting framework requires such accounting
- The substantive procedures for debt should be responsive to the identified risks. Common procedures include:
 - Summarizing and testing debt covenants
 - Reviewing new leases to determine if debt should be recorded
 - Confirming all significant debt with lenders
 - Determining if all debt is classified appropriately (as current or noncurrent)
 - Agreeing the end-of-period debt balances in the general ledger to the amortization schedules
 - Agreeing future debt service payment summaries to amortization schedules
 - Reviewing accruals of any significant interest
 - Reviewing interest expense (usually comparing current and prior year)

Now you know how to audit debt. Next we'll turn our attention to the audit of equity.