

CHAPTER 12

The Why and How of Auditing Equity

Auditing equity is easy, until it's not. Auditing equity is usually one of the easiest parts of an audit. For some equity accounts, you agree the year-end balances to the prior year ending balance, and you're done. For instance paid-in-capital seldom changes. Often, the only changes in equity are from current year profits and owner distributions. And testing those equity additions and reductions in equity usually takes just minutes.

Nevertheless, auditing equity can be challenging, especially for businesses that desire to attract investors. Such companies offer complicated equity instruments. Why? The desire to attract cash without giving away (too much) power. This balancing act can lead to complex equity instruments.

Regardless of whether a company's equity is easy to audit or not, below I show you how to focus on important equity issues.

Auditing Equity — An Overview

In this chapter, we will cover the following:

- Primary equity assertions
- Equity walkthroughs
- Directional risk for equity
- Primary risks for equity
- Common equity control deficiencies
- Risk of material misstatement for equity

- Substantive procedures for equity
- Common equity work papers

Primary Equity Assertions

First, let's look at assertions. Consider that equity comes in a variety of forms including:

- Common stock
- Paid-in-capital
- Preferred stock
- Treasury stock
- Accumulated other comprehensive income
- Noncontrolling interests
- Members' equity (for an LLC)
- Net assets (for a nonprofit)
- Net position (for a government)

Certain types of equity accounts are used for certain types of entities. For example, you'll find common stock in an incorporated business, net assets in nonprofits, and members' equity in a limited liability corporation.

The equity accounts used depend upon the type of entity and what occurs within and outside the organization. Examples include:

- Has an incorporated company purchased treasury stock?
- Does a nonprofit organization have donor-restricted contributions?
- Does a government have restricted net position?

It's a must that you understand the equity accounting requirements before you determine the relevant assertions.

Primary relevant equity assertions include:

- Existence and occurrence
- Rights and obligations
- Classification

When a company reflects equity on its balance sheet, it is asserting that the balance exists and that the equity transactions occurred. For example, if common stock is sold, the balance of the account is based upon the actual sale of stock and the monies received. In other words, the balance is properly recorded.

Equity instruments also have certain rights and obligations. For example, common stock provides rights to retained earnings. Some classes of stock provide voting privileges. Others do not.

Additionally, the classification of equity balances is important. Determining how to present equity is usually easy, but classification issues arise when an entity has convertible debt—is it debt or equity? Noncontrolling interests can also create questions about classification.

Equity Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions. Early in your audit, perform a walkthrough of equity to see if there are any control weaknesses.

Here are sample questions and steps to use in your walkthrough:

- What types of equity does the entity have? What are the rights of each class?
- How many shares are authorized? How many shares are issued?
- Does the company have convertible debt?
- Has the company declared and paid dividends?
- Does the company have accumulated other comprehensive income?

- Inspect ownership documents such as stock certificates.
- Read the minutes to determine if any new equity was issued or if there were any buy-backs of stock.
- Is the entity attempting to raise additional capital?
- Is there a noncontrolling interest in the company?
- Does the company have a stock compensation plan?
- For a nonprofit, are there any restricted donations?
- For a government, is the net position restricted?
- For a limited liability corporation, are there differing classes of ownership?

As you ask the above questions, consider examining equity-related information such as stock certificates, cash receipts from new equity issuances, general ledger accounts, related journal entries, minutes, and stock compensation plan documents. Don't just ask questions. Observe equity controls and inspect sample documents such as stock certificates.

As you perform walkthroughs, also consider if there are risks of material misstatement due to fraud or error.

Directional Risk for Equity

Third, consider the directional risk of equity.

The directional risk for equity is that it is overstated since companies desire strong equity positions. Thus, make sure you audit for existence.

Primary Risks for Equity

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

- Equity is intentionally overstated
- Equity is misclassified
- Errors in equity accounting

Common Equity Control Deficiencies

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

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

- One person performs two or more of the following:
 - Approves the sale of equity interests,
 - Records the new equity in the accounting system,
 - Deposits funds from the sale of equity instruments
- Accounting personnel lack sufficient knowledge regarding equity transactions and the requirements of the reporting framework (e.g., FASB)

Risk of Material Misstatement for Equity

Sixth, assess your risk of material misstatement in light of the information you've gathered. In most audit engagements, I assess control risk at high for each equity assertion.

In auditing equity, the assertions that concern me the most are existence and occurrence, rights and obligations, and classification. So, my inherent risk 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 equity transactions. Why? A company may desire to overstate its equity. Also, misclassifications or errors occur due to misunderstandings about equity accounting.

Substantive Procedures for Equity

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

My normal substantive tests for auditing equity include:

- Summarizing and reviewing all equity transactions
- Reviewing all equity accounts for proper classification
- Agreeing all beginning-of-period balances to the prior period's ending balances
- Reviewing equity disclosures for compliance with the reporting framework requirements (e.g., GAAP)

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

In light of my risk assessment and substantive procedures, what equity work papers do I normally include in my audit files?

Common Equity Work Papers

My equity work papers normally include the following:

- An understanding of equity-related internal controls
- Documentation of internal control deficiencies related to equity
- Risk assessment of equity at the assertion level
- Equity audit program
- A copy of equity instruments
- Minutes reflecting the approval of new equity or the retirement of existing equity
- A summary of equity activity (beginning balances plus new equity less equity reductions and ending balance)
- Disclosure checklist

Auditing Equity - A Simple Summary

- Primary relevant equity assertions include existence and occurrence, rights and obligations, and classification
- Perform a walkthrough of equity by making inquiries, inspecting documents, and making observations

- The directional risk for equity is that it is overstated
- Primary risks for equity include:
 - Equity is intentionally overstated
 - Equity is misclassified
 - Errors in equity accounting
- The substantive procedures for equity should be responsive to the identified risks. Common procedures include:
 - Summarizing and reviewing all equity transactions
 - Reviewing all equity accounts for proper classification
 - Agreeing all beginning-of-period balances to the prior period's ending balances
 - Reviewing equity disclosures for compliance with the reporting framework requirements (e.g., GAAP)

Now you know how to audit equity.

We've completed our journey through the transaction areas. It's time to shift gears and wrap up the audit.