

Where is That Long-Term Debt Program for Big Moo?: Instructor Guide

Title:

Where is That Long-Term Debt Program for Big Moo?

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Discipline:

Accounting

Target Audience

Intermediate, majors

Keywords

Audit, long-term debt

Length of Time/Staging

Two 75 minute classes.



Abstract

With this long-term debt problem, students will identify the types of evidence that they need and where they can get them (knowledge) to form an opinion about LTD. They will then need to determine the objectives and procedures for auditing LTD (knowledge and comprehension). Next, they will audit LTD using evidence provided by the client and others (provided by the instructor) and by following the procedures previously determined (application, and analysis). Finally, the students will reach a conclusion about the fairness of LTD (evaluation). With this problem, students need to use knowledge, comprehension, application, and the higher-order thinking skills of analysis and evaluation.

Date Submitted

2/20/2003

Date Published

3/30/2003

Format of Delivery

The problem is delivered in a cooperative learning setting. Teams of three work well. Direction from instructor as necessary.

Student Learning Objectives

After the completion of the long-term debt audit, students should be able to:

1. Identify the evidence needed to audit long-term debt and related accounts.
2. Know how and where to obtain such evidence.
3. List the objectives for auditing LTD.
4. List all procedures necessary to meet the objectives for auditing LTD.
5. Document the audit procedures used.
6. Use cross-referencing.
7. Write conclusions as to the fairness and proper classification of the balances in the account.
8. Describe a paperless audit.

Author's Teaching Notes

In the first class, hand out parts one and two of the problem. I usually have three students work in a group. After groups have finished part one (about 15 minutes), I ask each group to share their answers with the other groups. This helps all groups stay on track and gives the instructor the opportunity to add any important points that were not mentioned by the groups.

Next, the groups should begin part two by listing the objectives and corresponding procedures for auditing long-term debt. After about 20 minutes, I have a class discussion with each group giving an objective and procedure to meet that objective. After the discussion, each group can formalize the objectives and procedures in an audit program similar to the one shown below.



Notes Payable and Long-Term Debt

Audit Objectives

Recorded debt obligations include all notes payable, long-term debt, capital lease obligations, and other debt equivalents.

Debt obligations and related expenses are authorized and recorded correctly with respect to accounts, amounts, and periods. Debt obligations are properly classified in the balance sheet between current and noncurrent liabilities and adequate disclosures are made in accordance with GAAP, including:

1. Interest rates, maturities, restrictive covenants, and other significant features of the debt obligations.
2. Nature and amount of collateral, liens, and security agreements.

Substantive Audit Procedures

1. Obtain from the client an analysis of long-term debt (long-term debt schedule) and related interest including: issue date, maturity date, face amount, interest rate, collateral, principal balance at the beginning of the period, current period additions and payments, principal balance at the end of the period, accrued interest, current period expense and payments, and perform the following:
 - a. Test the mathematical accuracy of the analysis and trace balances to the general ledger (use financial statements as proxy for general ledger).
 - b. Determine that debt incurred in the current period has been properly authorized by reference to the board of directors' minutes.
 - c. Confirm outstanding balances and all debts retired in the current period including terms, restrictive covenants, and other pertinent conditions, and reconcile amounts shown per the confirmations to the balances shown per the analysis.
 - d. Obtain copies of new debt agreements and review terms and conditions (not given as supporting materials, so assume debt agreements agree with LTD schedule).
 - e. Test the reasonableness of interest expense, amortization of debt discount/premium, and related accrued interest.
2. Review compliance with restrictive covenants and determine effect on and disclosures required in financial statements.
3. Schedule the maturities of long-term debt for each of the five years following the balance sheet date.
4. Determine that disclosures of long-term debt and capital leases including terms, interest rates, maturities, and collateral, are properly made in the financial statements.

At the next class meeting, I hand out parts three and four and all the supporting files at the end of the problem handouts and in the problem folder. Students should follow the steps developed in their audit program, document their work, and reach a conclusion about the fairness of recorded long-term debt. Part three usually takes the whole class period and I spend about 20 minutes introducing students to proper cross-referencing and documentation. Part four can be done as an outside of class assignment.



Assessment Strategies

The LTD audit is one of 13 modules that my audit class uses to audit Big Moo Distributors. The total audit project is worth 165 points, with the LTD module worth about 12 points. Each assignment is graded and returned to groups in a timely manner with comments, questions, and suggestions for improvement. The assignments are reviewed and critiqued in a manner similar to the method a senior auditor would use to review a staff auditor's workpapers; that is, with questions about why certain procedures were used (or not used) to approach the problem and a list of "to do" points to improve the audit. If a mistake or error occurs frequently or by several groups, the problem and correct approach is discussed in class. As groups gain more experience with audit procedures, the audit documentation and work product in later modules show a marked improvement for most groups.

Solution Notes

Part 1

1. Types of evidence needed include the company's comparative financial statements and footnotes, long-term debt schedules, loan contracts and agreements, confirmations from the bank, evidence of cash receipts, evidence of payments of interest and portions of the loan on due dates, and approval by the board of directors.
2. Most evidence will be obtained from the client. The confirmation will come directly to the auditor from the bank.

Part 2

1. The objectives for auditing LTD are that all debt obligations have been recorded, that debt has been authorized and recorded accurately, and that debt is properly classified in the balance sheet and disclosed in the footnotes.
2. The procedures used to address these objectives include recalculating the math, tracing balances to the general ledger, tracing to the board of directors minutes, confirming details with the bank, reading new debt contracts, recalculating the interest expense, determining that disclosures are proper, and performing some analytical procedures such as comparing amounts to prior years and calculating the debt ratio. (See the Long-Term Debt program in the teaching notes.)

Part 3

1. The LTD schedule (solution.xls) should document the procedures described in part two. Note that the procedure used for the explanation for (#) cannot be done by the students, and for (x) students cannot review the First National Bank agreement, so the instructor should just dictate the tickmark explanation. A conclusion should be written as to the fairness and proper classification of LTD.

Part 4

1. The auditing profession has become increasingly interested in performing "paperless audits." Software has been developed to assist staff in planning and risk



assessments. Applications have been developed that allow an engagement team to perform virtually all of their work via computer. Paperless audits can increase effectiveness and efficiency. Effectiveness can be improved by using the software to guide the professional judgments required of engagement team members, and by defining the way auditors perform, document, and organize their work. Improved portability of the work product also enhances efficiency. Work that is documented electronically can easily be transmitted to other team members or to reviewers for their use. Even though many smaller firms do not yet have electronic engagement software, most currently use computers in some manner during their audits-often to prepare memos and spreadsheets as part of the engagement workpapers.

(<https://tax.thomsonreuters.com/press-room/in-the-news/getting-closer-paperless/>, 2001)

2. Advantages include having a more effective and efficient audit as described above. Disadvantages include deletion of files, cost of software, cost of training of employees, and duplication of electronic and hardcopies of the files.