Functions and Related Controls

The following **financing functions** and related control activities are associated with the financing cycle:

- *Authorizing bonds and capital stock.* The board of directors usually authorizes financing transactions based on its strategic plans and investing activities.
- *Issuing bonds and capital stock.* Issues are made in accordance with board of directors authorizations and legal requirements, and proceeds are promptly deposited intact; unissued bond and stock certificates are physically safeguarded.
- *Paying bond interest and cash dividends.* Payments are made to proper payees in accordance with board of directors or management authorizations.
- *Redeeming and reacquiring bonds and capital stock.* Transactions are executed in accordance with board of directors authorizations; treasury stock certificates are physically safeguarded.
- *Recording financing transactions.* Transactions are correctly recorded as to amount, classification, and accounting period based on supporting authorizations and documentation; the duties of executing and recording financing transactions are segregated; periodic independent checks are made of agreement of subsidiary ledgers and control accounts, including confirmation with the **bond trustee** or **transfer agent,** if applicable.

Major financing transactions (authorizing and issuing debt, bonds, or capital stock) usually require involvement of the board of directors (EO1, EO3). Controls over the routine payment of principal and interest are usually subject to the standard internal controls in the expenditure cycle (EO2, VA2, PD2). Dividends require board of directors authorization and are usually handled by an outside transfer agent (EO3, VA3, PD3). Controls over the completeness of transactions usually involve the regular review of the disclosure committee, particularly with respect to accounting for any transactions involving variable interest entities (C1-3, PD1-3). An independent review of the amortization of bond premium or discounts also falls within the responsibilities of a disclosures committee. This review is usually performed when the bond is issued (VA1-2).

Management normally maintains subsidiary records of loan balances. It is common for the Treasury Department to establish independent checks of such balances against monthly statements sent by lenders (EO4, C4, RO1, VA4). Equity transactions are usually rare. In a private company the Treasury Department usually maintains controls over stock certificates. Public companies usually outsource these transactions to a transfer agent. Often a quarterly reconciliation is sufficient (EO5, C5, RO2, VA5). Finally, the disclosure committee should review all financial statement disclosures before they are presented to the auditor (PD4-11).

PRELIMINARY AUDIT STRATEGIES FOR LONG-TERM DEBT

Audit Decision 9

- **What is involved in determining a preliminary audit strategy and planning an audit program for substantive tests for long-term debt?**

Figure 17-9 summarizes some key issues related to preliminary audit strategies for the audit of long-term debt. This is an area where the significant inherent risk is a risk of unrecorded liabilities. Auditors will want to ascertain whether financing and investing activities are consistent with each other. Auditors may follow slightly different approaches for public and private companies. Public companies will often have effective controls over borrowing. However, most private companies may

Figure 17-9 ■ Preliminary Audit Strategies for Long-Term Debt

Assertion	Inherent Risk	Control Risk	Analytical Procedures Risk	Test of Details Risk
Existence and Occurrence	Moderate: The existence of recorded debt is not a significant inherent risk.	Low: The Treasury Department should regularly compare existing debt with monthly statements from lenders.	Moderate: Comparing financial data and linking investing activities with financing activities disclose misstatements.	High: The auditor will usually directly confirm borrowing arrangements with lenders.
Completeness	Maximum: There is a significant inherent risk associated with unrecorded liabilities. This is an important risk if a company uses a variable interest entity to finance property acquisitions.	Moderate or High: Primary controls include involvement of the board of directors and effective disclosure committees.	High: Comparison of financial numbers may not necessarily disclose unrecorded liabilities.	Low: Direct confirmation of borrowing arrangements, including entities that have lent funds in the past but currently have zero balances.
Rights and Obligations	High: An important inherent risk represents understanding the collateral that may be pledged as security for a loan.	Moderate or High: Primary control is the involvement of an effective disclosures committee.	Maximum: Analytical procedures are not directed at the rights and obligations assertion.	Low: Direct confirmation of borrowing arrangements will include information about assets pledged as security for loans. The auditor will also read the contracts to understand terms of borrowing.
Valuation or Allocation	Moderate: The valuation of recorded debt is not high. The calculations associated with debt are not complex.	Moderate or Low: Independent review of principal and interest calculations.	Moderate or low: Analytical procedures are often used to test the reasonableness of interest expense.	High: The auditor will usually directly confirm amounts of outstanding borrowing and accrued interest with lenders.
Presentation and Disclosure	High or Maximum: There are numerous debt disclosures that need to be addressed.	Moderate or Maximum: Primary control is the involvement of an effective disclosures committee.	Maximum: Analytical procedures are not directed at disclosures.	Low: The auditor will often perform tests of details to evaluate the quality and accuracy of financial statement disclosures. The auditor will also read the contracts to understand terms of borrowing.

have neither a significant treasury function nor an effective disclosure committee. Even with strong controls, debt instruments are usually small in number, even for large companies. This makes confirmation of debt a cost-effective audit approach.

SUBSTANTIVE TESTS OF LONG-TERM DEBT

Figure 17-10 shows a list of possible substantive tests of long-term debt balances together with the specific audit objectives to which each test relates. As in the case

Figure 17-10 ■ Possible Substantive of Long-Term Debt Assertions

Category	Substantive Test	Specific Audit Objectives
Initial Procedures	1. Obtain an understanding of the business and industry and determine:	All
	a. The significance of various sources of financing (debt and equity) to the entity	
	b. Key economic drivers that influence the entity's need for financing and its ability to service the cost of debt and equity.	
	c. Industry standards for the extent to which the industry uses debt and equity financing and the impact of debt on earnings.	
	d. Understand the degree to which the company has used variable interest entities and operating leases to finance assets.	VA4
	2. Perform initial procedures on long-term debt balances and records that will be subject to further testing.	EO1, EO4
	a. Trace beginning balance for long-term debt accounts to last year's working papers.	VA4
	b. Review activity in all long-term debt and related income statement accounts and investigate entries that appear unusual in amount or source.	VA4
	c. Obtain client-prepared schedules of long-term debt and determine that they accurately represent the underlying accounting records from which they were prepared by:	VA4
	i. Footing and crossfooting the schedules and reconciling the totals with increases or decreases in related subsidiary and general ledger balances.	
	ii. Testing agreement of items on schedules with entries in related subsidiary and general ledger accounts.	
Analytical Procedures	3. Perform analytical procedures:	All
	a. Calculate ratios: (see Figure 17-8)	
	b. Analyze ratio results relative to expectations based on prior year, budget, industry, or other data.	
Tests of Details of Transactions	4. Vouch a sample of entries in long-term debt and related interest expense accounts.	EO1, VA1, PD1 EO2, VA2, PD2
Tests of Details of Balances	5. Review authorizations and contracts for long-term debt.	EO4, C1, C4, RO1, VA4
	6. Confirm debt with lenders and bond trustees.	EO4, C1, C4, RO1, VA4
	7. Recalculate interest expense.	EO2, C2, VA2, PD2
Presentation and Disclosure	8. Compare statement presentation with GAAP.	
	a. Determine that long-term debt balances are properly identified and classified in the financial statements.	PD4, PD7
	b. Determine the appropriateness of disclosures concerning all terms, covenants, and retirement provisions pertaining to long-term debt.	PD4, PD7
	c. Evaluate the completeness of presentation and disclosures for long-term debt in drafts of financial statements to determine conformity to GAAP by reference to disclosure checklist.	PD5
	d. Read disclosures and independently evaluate their classificaiton and understandability.	PD6

of accounts payable in Chapter 15, the auditor is primarily concerned about the understatement (completeness assertion) of long-term debt. The auditor relies primarily on (1) direct communication with outside independent sources, (2) review of documentation, and (3) recomputations in obtaining sufficient competent evidential matter about the assertions pertaining to long-term debt balances. Audit working papers, such as the analysis of long-term notes payable and interest in Figure 17-11, are used to document the auditor's tests. Each of the substantive tests is explained in a following section.

Initial Procedures

As shown in Figure 17-10, the familiar initial procedures are applicable to long-term debt balances. It is important to obtain an understanding of the business and industry, and determine the entity's need for external financing and its ability to service debt. Because financing is so clearly linked to investing activities, the auditor may perform these procedures simultaneously.

The schedules associated with long-term debt may include separate schedules of long-term notes payable to banks, obligations under capital leases, and listings of registered bondholders prepared by bond trustees. As in each of the previous listings of possible substantive tests, these procedures pertain to the mathematical and clerical accuracy component of the valuation or allocation assertion, and are performed preparatory to using the long-term debt schedules as a basis for additional substantive tests.

Analytical Procedures

An important part of auditing long-term debt is determining that the financial information subjected to audit is consistent with the auditor's expectations. The earlier discussions regarding knowledge of the entity and its environment and analytical procedures risk addressed procedures that the auditor might perform to assess the reasonableness of financial statement information regarding long-term debt and interest expense (Figure 17-8). The auditor should also evaluate the disclosures regarding the maturities of debt and debt covenants. As part of the auditor's responsibilities with respect to evaluating whether an entity is a going concern, the auditor will evaluate the entity's ability to generate sufficient cash flow to meet commitments regarding interest expenses (including capitalized interest), debt maturities, and debt covenants. When performing analytical procedures, the auditor should maintain an appropriate level of professional skepticism and investigate abnormal results.

Tests of Details of Transactions

For bonds, the auditor should obtain evidence on both the face value and net proceeds of the obligation at the date of issue. Issuances of debt instruments should be traced to cash receipts as evidenced by brokers' advices. Payments on principal of long-term debt can be verified by an examination of vouchers and canceled checks; payments in full can be validated by an inspection of the canceled notes or bond certificates. When installment payments are involved, their propriety can be traced to repayment schedules. Bonds may also be converted into stock. Evidence of such transactions is available in the form of canceled bond certificates and the issuance of related stock certificates.

Figure 17-11 ■ Notes and Interest Payable Working Paper

WILLIAMS COMPANY
LONG-TERM PAYABLE AND ACCRUED INTEREST
DECEMBER 31, 20X1

W/P REF: N-3
PREPARED BY: C.J.G. DATE: 1/24/x2
REVIEWED BY: R.C.P. DATE: 1/30/x2

ACCTS. 220, 225, 475

DESCRIPTION	NOTES PAYABLE				INTEREST PAYABLE			
	BALANCE 1/1/X1	ADDITIONS	PAYMENTS	BALANCE 12/31/X1	BALANCE 1/1/X1	EXPENSE	PAYMENTS	BALANCE 12/31/X1
10% NOTE PAYABLE TO CULVER NATIONAL BANK, DUE $100,000 PER YEAR TO 7/1/X3 (1)	300,000 √		100,000 ø	200,000 (CI)	15,000	25,000 (R)	30,000	10,000
9% NOTE PAYABLE TO FIRST TRUST COMPANY, DUE 9/1/X3 (2)		250,000 √ ø		250,000 (CI)		7,500 (R)		7,500
	300,000	250,000	100,000	450,000	15,000	32,500	30,000	17,500
	F	F	F	FF To N-1	F	F To S-5	F	FF To M-1

(1) Long-term investments in stock of Afton Co. and Boley Inc pledged as security-see confirmation received from bank-A-4
(2) Land and building pledged as security-see bank confirmation-A-5
Traced to prior years working papers
Traced to ledger at 12/31/x1
(CI) Confirmed by bank-see A-4 and A-5
√ Examined copy of note
Traced to cash journal and supporting documentation
(R) Recomputed interest expense-no exception
F Footed
FF Footed and crossfooted

When bond interest is paid by an independent agent, the auditor should examine the agent's reports on payments. The vouching of entries to long-term debt accounts provides evidence about the following four assertions: existence or occurrence (EO1-2), completeness (C1-2), rights and obligations (RO1), and valuation or allocation (VA1-2). Again, the completeness assertion is addressed only in the sense that vouching debits to long-term debt provides evidence that entries made to reduce debt balances are not invalid. Vouching recorded entries will not reveal unrecorded long-term debt.

Tests of Details of Balances

There are three substantive tests in this category: (1) review authorizations and contracts for long-term debt, (2) confirm debt with lenders and bond trustees, and (3) recalculate interest expense.

Review Authorizations and Contracts

The authority of a corporation to enter into a contractual agreement to borrow money through the issuance or incurrence of long-term debt rests with the board of directors. Accordingly, evidence of authorizations should be found in the minutes of board meetings. Normally, the auditor reviews only the authorizations that have occurred during the year under audit because evidence of the authorizations for debt outstanding at the beginning of the year should be in the permanent working paper file.

Authorization for the debt issue should include reference to the applicable sections of the bylaws that pertain to such financing. It may also include the opinion of the company's legal counsel on the legality of the debt. The review of contracts should also include the details of covenants and the entity's compliance therewith, and the details of obligations under capital leases. Evidence obtained from this test may pertain to all five assertion categories (see Figure 17-10).

Confirm Debt

The auditor is expected to confirm the existence and nature of long-term debt by direct communication with lenders and bond trustees. Notes payable to banks in which the client has an account are confirmed as part of the confirmation of bank balances as explained in Chapter 18. Other notes are confirmed with the holders by separate letter. Such requests should be made by the client and mailed by the auditor. The existence of mortgages and bonds payable normally can be confirmed directly with the trustee. Each confirmation should include a request for the current status of the debt and current year's transactions. All confirmation responses should be compared with the records, and any differences should be investigated. Confirming long-term debt and key requirements of the contract relates to all assertion categories (see Figure 17-10).

Recalculate Interest Expense

Evidence of interest expense and accrued interest payable is easily obtainable by the auditor. The auditor reperforms the client's interest calculations and traces interest payments to supporting vouchers, canceled checks, and confirmation responses. Accrued interest, in turn, is verified by identifying the last interest payment date and recalculating the amount booked by the client.

When bond interest coupons are involved, the auditor can examine the canceled coupons and reconcile them to the amount paid. When bonds are originally sold at a premium or discount, the auditor should review the client's amortization schedule and verify the recorded amount of amortization by recalculation. This test is directed primarily at the existence or occurrence (EO1,2), valuation or allocation (VA1,2), and completeness assertions (C1,2) for interest expense and interest payable. It also provides evidence about the rights and obligations assertion (RO1) for interest payable.

Tests of Details of Presentation and Disclosure

In evaluating the appropriateness of the client's classification and disclosure of long-term debt, the auditor should be aware of applicable FASB Statements on Financial Accounting Standards (SFASs). The foregoing tests of inspecting and reading debt contracts and confirming the terms of debt provide the client data for use in the comparison. This test relates to the presentation and disclosure assertion (PD4-7).

LEARNING CHECK

17-10 a. Describe the nature of the financing cycle.
b. Identify other cycles that interface with the financing cycle.

17-11 State the specific audit objectives that apply to the financing cycle.

17-12 a. Discuss the issues associated with materiality and inherent risk as they relate to the financing cycle.
b. Identify four analytical procedures that the auditor might perform and explain how they might assist in evaluating the reasonableness of debt and equity balances and transactions.

17-13 Discuss the applicability of the internal control structure components to financing cycle transactions.

17-14 State and describe the functions that relate to financing cycle transactions.

17-15 What factors pertain to determining the acceptable level of detection risk for long-term debt transactions?

17-16 What substantive tests apply to the existence and valuation assertions for long-term debt balances?

17-17 Describe the nature of each of the following substantive tests and indicate the assertions to which each relates:
a. Vouch entries to long-term debt accounts.
b. Confirm debt.
c. Recalculate interest expense.

KEY TERMS

Bond trustee, p. 824
Financing cycle, p. 821
Financing functions, p. 824
Long-term debt transactions, p. 821
Stockholders' equity transactions, p. 821
Transfer agent, p. 824

Audit Decision 10

■ What is involved in determining a preliminary audit strategy and planning an audit program for substantive tests for shareholders' equity?

PRELIMINARY AUDIT STRATEGIES FOR SHAREHOLDERS' EQUITY

Figure 17-12 summarizes some key issues related to preliminary audit strategies for the audit of shareholders' equity. The highest inherent risk is associated with the presentation and disclosure assertion. Some companies use equity instruments that behave like debt and should not be classified in shareholders' equity.

Figure 17-12 ■ Preliminary Audit Strategies for Shareholders' Equity

Assertion	Inherent Risk	Control Risk	Analytical Procedures Risk	Test of Details Risk
Existence and Occurrence	Moderate: The existence of recorded equity transactions and balances is not a significant inherent risk.	Low: Routine stock transactions are usually handled by a registrar or transfer agent.	High: Comparison of financial numbers may not necessarily disclose misstatements in equity accounts.	High: The auditor will usually directly confirm equity transactions and balances with the registrar or transfer agent.
Completeness	Moderate: There is only a modest risk associated with unrecorded equity transactions.	Low: Routine stock transactions are usually handled by a registrar or transfer agent. The auditor is normally involved in a new registration statement associated with new issues of stock. These transactions often have significant board of directors oversight.	High: Comparison of financial numbers may not necessarily disclose misstatements in equity accounts.	High: The auditor will usually directly confirm equity transactions and balances with the registrar or transfer agent.
Rights and Obligations	High: An important inherent risk represents understanding the collateral that may be pledged as security for a loan.	Low: Routine stock transactions are usually handled by a registrar or transfer agent.	Maximum: Analytical procedures are not directed at the rights and obligations assertion.	Low: The auditor will usually directly confirm equity transactions and balances with the registrar or transfer agent.
Valuation or Allocation	Moderate: The valuation of recorded equity is not high. The calculations associated with equity are not complex.	Low: Routine stock transactions are usually handled by a registrar or transfer agent.	High: Comparison of financial numbers may not necessarily disclose misstatements in equity accounts.	High: The auditor will usually directly confirm equity transactions and balances with the registrar or transfer agent.
Presentation and Disclosure	High or Maximum: Some companies use equity instruments that are in economic substance debt. These should not be included in shareholders' equity.	Moderate or Maximum: Primary control is the involvement of an effective disclosure committee.	Maximum: Analytical procedures are not directed at disclosures.	Low: The auditor will often perform tests of details to evaluate the quality and accuracy of financial statement classifications and disclosures.

For most assertions related to shareholders' equity, substantive tests of transactions and balances are cost effective and efficient.

SUBSTANTIVE TESTS OF STOCKHOLDERS' EQUITY

Figure 17-13 shows a list of possible substantive tests of stockholder's equity balances together with the specific audit objectives to which each test relates. The auditor relies primarily on (1) direct communication with outside independent sources and (2) review of documentation to obtain sufficient competent evidential matter about the assertions pertaining to shareholders' equity. Audit working papers, such as the analysis of shareholders' equity in Figure 17-15, are used to document the auditor's tests. Each of the substantive tests is explained in a following section.

Initial Procedures

The auditor should obtain an understanding of the business and industry and determine (1) the entity's need for external financing and (2) the desirability of using equity financing to support the growth of the entity. Equity financing might be used either to support investing activities or to support needed investments in working capital (e.g., growth in inventories and receivables needed to grow the entity).

The schedules referred to in Figure 17-13 for this group of procedures might include a trial balance of the stockholders' ledger or listings of stockholders supplied by the registrar and transfer agent. The auditor should test the agreement of the data in the schedules with any underlying accounting records and verify that the schedules or subsidiary ledgers agree with general ledger control accounts. This evidence pertains to the mathematical and clerical accuracy component of the valuation or allocation assertion.

Analytical Procedures

Figure 17-14 presents several ratios commonly used to evaluate the reasonableness of stockholders' equity. The financial relationships expressed in these ratios may be helpful in evaluating the reasonableness of stockholders' equity balances. The evidence obtained from these analytical procedures pertains to the existence or occurrence, completeness, and valuation or allocation assertions.

Tests of Details of Transactions

This category of tests includes vouching entries in the paid-in capital and retained earnings accounts as explained in the following sections.

Vouch Entries to Paid-in Capital Accounts

Each change in a capital stock account should be vouched to supporting documentation. For a new issue of stock, the auditor can examine remittance advices of the cash proceeds from the issue. If the consideration for the shares was other than cash, the auditor should carefully examine the basis for the valuation, such as the market value of the consideration received or given. For the shares issued, market quotations may be useful in determining the propriety of the valuation; when the value of the property received is used, an appraisal may be necessary.

Figure 17-13 ■ Possible Substantive Tests of Stockholders' Equity Assertions

Category	Substantive Test	Specific Audit Objectives
Initial Procedures	1. Obtain an understanding of the business and industry and determine:	All
	a. The significance of various sources of financing (debt and equity) to the entity	
	b. Key economic drivers that influence the entity's need for financing and its ability to obtain equity capital and pay dividends.	
	c. Industry standards for the extent to which the industry uses equity financing.	
	2. Perform initial procedures on stockholders' equity balances and records that will be subject to further testing.	
	a. Trace beginning balance for stockholders' equity accounts to last year's working papers.	VA5
	b. Review activity in stockholders' equity accounts and investigate entries that appear unusual in amount or source.	EO3
	c. Obtain client-prepared schedules of changes in stockholders' equity balances and determine that they accurately represent the underlying accounting records from which they were prepared by:	VA5
	i. Footing and crossfooting the schedules and reconciling the totals with increases or decreases in related subsidiary and general ledger balances.	VA5
	ii. Testing agreement of items on schedules with entries in related subsidiary and general ledger accounts.	VA5
Analytical Procedures	3. Perform analytical procedures:	All
	a. Calculate ratios	
	• Return on common stockholders' equity	
	• Equity to total liabilities and equity	
	• Dividend payout rate	
	• Earnings per share	
	• Sustainable growth rate	
	4. Analyze ratio results relative to expectations based on prior-year, budget, industry, or other data.	All
Tests of Details of Transactions	5. Vouch entries in paid-in capital account.	EO3, VA3, PD3
	6. Vouch entries in retained earnings.	EO3, VA3, PD3
Tests of Details of Balances	7. Review articles of incorporation and bylaws.	All
	8. Review authorizations and terms of stock issues.	EO5, C3, C5, RO2
	9. Confirm shares outstanding with registrar and transfer agent.	EO5, C3, C5, VA5
	10. Inspect stock certificate book.	EO5, C3, C5, RO2
	11. Inspect certificates of shares held in treasury.	EO5, C3, C5, RO2
Presentation and Disclosure	12. Compare statement presentation with GAAP.	PD8, PD11
	a. Determine that stockholders' equity balances are properly identified and classified in the financial statements.	PD8, PD11
	b. Determine the appropriateness of disclosures concerning all changes in stockholders' equity account balances during the period, par or stated values, dividend and liquidation preferences, dividends in arrears, stock option plans, conversion features, and treasury shares.	PD9
	c. Evaluate the completeness of presentation and disclosures for stockholders' equity in drafts of financial statements to determine conformity to GAAP by reference to disclosure checklist.	PD10
	d. Read disclosures and independently evaluate their understandability.	PD10

Figure 17-14 ■ Analytical Procedures Commonly Used to Audit Shareholders' Equity

Ratio or Other Financial Information	Formula	Audit Significance
Return on common stockholders' equity	(Net income – preferred dividends) / average common stockholders' equity	Provides a measure of the rate of return generated on the common shareholders' investment. Auditors should understand the competitiveness factors that allow a company to obtain a unusually high return.
Equity to total liabilities and equity	Stockholders' equity / (stockholders' equity + total liabilities)	Provides a reasonableness of the entities' proportion of equity that may be compared with prior years' experience or industry data.
Dividend payout rate	Cash dividends/ net income	Auditors would normally expect low-dividend payout rates for high-growth companies that need reinvested earnings to fund investments in working capital and long-term assets.
Earnings per share	Net income / weighted average common shares outstanding	Earnings per share is useful for comparisons with price per share. This ratio can be compared with industry price earnings ratios for reasonableness.
Sustainable growth rate	Return on common equity * (1-dividend payout rate)	Provides an estimate of rate of sales growth that can be obtained without changing the entity's profitability or financing structure. The auditor should expect changes in the financing structure when sales grow significantly faster than the sustainable growth rate.

An analysis of a capital stock account is illustrated in Figure 17-15. Similar analyses are prepared for treasury stock and other stockholders' equity accounts.

The auditor should exercise care in determining the propriety of the accounting treatment for shares issued as part of stock option, stock warrant, or stock conversion plans or in connection with a stock split. Documentation of the cost of treasury stock should be available to the auditor in the form of authorizations in the minutes, disbursement vouchers, and canceled checks.

Evidence from vouching of entries to capital stock accounts relates most closely to the existence or occurrence, rights and obligations, and valuation or allocation assertions.

Vouch Entries to Retained Earnings

Each entry to retained earnings except the posting of net income (or net loss) should be vouched to supporting documentation. Entries for dividend declarations and retained earnings appropriations are traced to the minutes book. In determining the propriety of the distribution, the auditor should:

- Establish that preferential or other rights of stockholders and any restrictions on dividend distributions have been recognized.

Figure 17-15 ■ Capital Stock Working Paper

Prepared by: A.E.R. Date: 1/12/x2

Reviewed by: R.C.P. Date: 1/12/x2

P-2

Willems Company

Capital Stock $100 par

12/31/x1

Acc. # 600

	Shares Authorized	Shares Issued and outstanding	Amount	
Balances, 1/1/x1	10000 √	5000 √	500000 √	
Shares issued at par for cash on 4/1/x1		1000 ⋀	100000 ⋀ ∅	
Balances, 12/31/x1	10000	6000 C	600000	To-P-1

√ Traced to prior years working papers

⋀ Traced to approval per minutes of Board of Directors meeting on 3/20/x1

∅ Traced proceeds to cash receipts

C Confirmed by First Trust Company transfer agent for the company - See P-3

Reviewed minutes of all Board of Directors meetings for evidence of capital stock transactions. Only reference was to transaction of 4/1/x1 as per above.

- Establish the number of shares outstanding on the date of record and verify the accuracy of the total dividend declaration by recalculation.
- Ascertain the propriety of the entry to record the declaration.
- Trace dividend payments to canceled checks and other documentation.

The client is also expected to furnish support for any prior-period adjustments. Vouching enables the auditor to ascertain whether (1) a proper distinction has been made between paid-in capital and retained earnings and (2) applicable legal and contractual requirements have been met. In addition to the valuation or allocation assertion, this test also relates to the existence or occurrence and rights and obligations assertions.

Tests of Details of Balances

Substantive tests in this category are explained in the next five sections.

Review Articles of Incorporation and Bylaws

Copies of the articles of incorporation and the bylaws should be in the auditor's permanent working paper file in the audit of a continuing client. The auditor should inquire of management and the client's legal counsel about changes in either or both of the documents. Preferably, the responses from both parties should be in writing.

In the initial audit of a corporation, the auditor will make an extensive review of the articles and bylaws and note key matters in his working papers. This substantive test is designed to determine that capital stock has been legally issued and that the board of directors has been acting within the scope of its authority. Thus, this test provides important evidence about the existence or occurrence and rights and obligations assertions.

Review Authorizations and Terms of Stock Issues

All stock issues, stock reacquisitions, and dividend declarations should be authorized by the board of directors. Accordingly, a review of the minutes should provide evidence of stockholders' equity transactions authorized during the year.

Different classes of stock may contain restriction provisions or convey preferences in dividend declarations and liquidation. The auditor should examine each issue for such terms and make appropriate notations in the working papers. This substantive test relates to the existence or occurrence and rights and obligations assertions.

Confirm Shares Outstanding with Registrar and Transfer Agent

When the client uses a **registrar,** the auditor should confirm total shares authorized, issued, and outstanding at the balance sheet date with the registrar. Confirmation with the **transfer agent,** in turn, provides evidence of shares held by each stockholder. The confirmation responses are then compared with the capital stock accounts and the stockholders' ledger. The confirming of shares outstanding relates to the following three assertions: existence or occurrence, completeness, and rights and obligations.

Inspect Stock Certificate Book

This test is required when the client serves as its own transfer agent. Several steps are involved in the test. First, the auditor should examine the stock certificate book to determine that (1) stubs for shares issued and outstanding have been properly filled out, (2) canceled certificates are attached to original stubs, and (3) all unissued certificates are intact. Second, the auditor should ascertain that the changes during the year have been correctly recorded in the individual stockholders' accounts in the subsidiary ledger. When there are numerous issuances and cancellations, this comparison may be done on a test basis. Third, the auditor should reconcile the total shares issued and outstanding as shown in the stock certificate book with total shares reported in the stockholders' ledger and capital stock accounts. This test relates to the same assertions as confirming shares with the registrar and transfer agent.

Inspect Certificates of Shares Held in Treasury

If capital stock is held in the treasury, the auditor should count the certificates at the same time other securities are counted. Ideally, the count should be made at the balance sheet date. If this is not possible, there must be a reconciliation from the date of the count to the balance sheet date. The number of shares held should also be agreed to the shares shown in the treasury stock account. In inspecting the certificates, the auditor should note in the working papers the number of shares acquired during the year for subsequent tracing to the cash records.

This test pertains to the following three assertions: existence or occurrence, completeness, and rights and obligations.

Tests of Details of Presentation and Disclosure

APB Opinion No. 12 provides that disclosure of changes in the separate accounts comprising stockholders' equity is required to make the financial statements sufficiently informative. Such disclosure may be made in the basic statements and notes thereto or be presented in a separate statement.

Disclosures related to the equity section include details of stock option plans, dividends in arrears, par or stated value, and dividend and liquidation preferences. The auditor obtains evidence about the presentation and disclosure assertion from the foregoing tests and from a review of the corporate minutes for provisions and agreements affecting the stockholders' equity accounts. In reviewing the minutes, the auditor should note whether any shares of stock have been reserved for stock option or similar plans, commitments for future issuance of stock in the purchase of or merger with another company, and restrictions limiting dividend payments or requiring minimum working capital requirements. Relevant evidence may also be obtained from discussions and communications with legal counsel.

When evaluating the appropriateness of the client's classification and disclosure of shareholders' equity, the auditor should be aware of applicable FASB Statements on Financial Accounting Standards (SFASs). For example, SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity,* indicates that some equity instruments used by companies behave more like debt than equity and, therefore, should not be classified as shareholders' equity. The foregoing tests of shareholders' equity should provide the basis for evaluating disclosures. This test relates to the presentation and disclosure assertion (PD8–11).

OTHER SERVICES

Audit Decision 11

■ How does the auditor use the knowledge obtained during the audit of the investing and financing cycles to support other assurance services?

When the auditor has completed the audit of investing activities, the auditor is in a position to evaluate the entity's investments relative to others in the industry. Auditors are uniquely positioned to provide two important services. First, the auditor can evaluate how effective the entity has been in utilizing its assets to generate sales, profits, and cash flows, and accomplish the entity's goals. This is an important performance measurement service. Second, the auditor is then positioned to provide independent advice by evaluating the entity's planned investing activities and determining whether the planned steps best support its goals.

Auditors also have significant knowledge and experience in understanding the sources of financing used by various entities to finance strategic investments. Auditors have knowledge of the advantages and disadvantages of bank financing, mortgage financing, lease financing, financing that may be available from insurance companies or other entities, or various classes of preferred stock. CPAs are in an excellent position to advise clients on how to finance important investments.

Finally, many investments are accomplished through merger or acquisition. Many CPA firms are experts in guiding a company through a merger or acquisition. This service would include identifying possible acquisitions candidates, helping an entity evaluate the potential benefits and risks associated with an acquisition, as well as how to structure the acquisition. Each of the foregoing represents possible services that build on the knowledge obtained during an audit of the investing and financing cycle.

LEARNING CHECK

17-18 What considerations apply to determining the acceptable level of detection risk for stockholders' equity balances?

17-19 What substantive tests apply to the existence or occurrence and completeness assertions for stockholders' equity balances?

17-20 Identify the ratios that may be used in applying analytical procedures to stockholders' equity balances.

17-21 Identify three different value-added services that a CPA might perform for a client, related to the investing and financing cycles.

KEY TERMS

Registrar, p. 836

Transfer agent, p. 836

FOCUS ON AUDIT DECISIONS

This chapter focuses on the practical aspects of auditing the investing and financing cycles. The chapter pays particular attention to audit planning concerns related to the investing and financing cycles, specific internal controls that are tailored to each cycle, and substantive tests for each cycle. Figure 17-16 summarizes the audit decisions discussed in Chapter 17 and provides page references indicating where these decisions are discussed in more detail.

Figure 17-16 ■ Summary of Audit Decisions Discussed in Chapter 17

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D1: What is the nature of the investing and financing cycles?	This chapter discusses audit procedures for items normally found in the investing and financing sections of the statement of cash flows. Investing activities are the purchase and sale of land, buildings, equipment, and other assets not generally held for resale. In addition, investing activities include the purchase and sale of financial instruments not intended for trading purposes (discussed in Chapter 18). Financing activities include transactions and events whereby cash is obtained from or repaid to creditors (debt financing) or owners (equity financing). The chapter illustrates the audit of investing activities in the context of plant assets. It illustrates the audit of financing activities in the context of long-term debt and shareholders' equity accounts.	pp. 806–807
D2: How does understanding the entity and its environment influence audit planning decisions in the investing and financing cycles?	Investing and financing activities are often linked closely together. When companies acquire long-term assets, they normally use some form of financing activity to fund the acquisition. These accounts are often audited together because the business linkage between these transactions is so closely tied together.	p. 807
D3: How are specific audit objectives developed for the audit of plant assets in the investing cycle?	Figure 17-2 uses the framework discussed in Chapter 6 to develop specific audit objectives for the audit of plant assets.	pp. 809–810
D4: What audit planning decisions should be made when developing an audit program for the plant assets?	Figure 17-3 presents a number of analytical procedures that are commonly used when auditing plant assets, along with a discussion of their audit significance. Almost every assertion in the investing cycle for plant assets involves important inherent risks. Some key risks are identified below and discussed in more detail in the chapters. (E&O) Capitalizing items that should be expensed; (C) the use of variable interest entities to acquire the use of assets and keep assets and debt off the balance sheet; (RO) long-term assets are often pledged as collateral for financing; (VA) accounting estimates of depreciation and asset impairment. Additional inherent risk factors are discussed in the chapter.	pp. 810–812
D5: What factors are involved in determining an acceptable level of tests of details risk for plant assets?	Figure 17-4 outlines one possible preliminary audit strategy for each assertion in the investing cycle for plant assets. Because there is often little turnover of plant assets, audit strategies often focus on tests of transactions for plant assets.	pp. 812–813
D6: How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for plant assets?	This section uses the framework developed in Chapter 12 to design substantive tests for plant assets. Figure 17-5 focuses on the nature of substantive tests for plant assets. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, tests of details of accounting estimates, and tests of details of disclosures relevant to the expenditure cycle. The chapter discussion explores these tests in more detail.	pp. 814–820

(continues)

Figure 17-16 ■ (Continued)

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D7: How are specific audit objectives developed for long-term debt and shareholder's equity in the financing cycle?	Figure 17-7 uses the framework discussed in Chapter 6 to develop specific audit objectives for the audit of long-term debt and shareholders' equity.	p. 821
D8: What audit planning decisions should be made when developing an audit program for the financing cycle?	Figures 17-8 and 17-14 present a number of analytical procedures that are commonly used when auditing financing cycle accounts, along with a discussion of their audit significance. The primary inherent risk factor for long-term debt is associated with the completeness assertion associated with unrecorded liabilities and off-balance sheet financing. Some equity instruments behave like debt and should not be classified in shareholders' equity. Other inherent risk factors are included in the chapter discussion.	pp. 821–824
D9: What is involved in determining a preliminary audit strategy and planning an audit program for substantive tests for long-term debt?	Figure 17-9 outlines one possible preliminary audit strategy for each assertion in the financing cycle for long-term debt. This section also uses the framework developed in Chapter 12 to design substantive tests for the financing cycle. Figure 17-10 focuses on the nature of substantive tests for long-term debt. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, and tests of details of disclosures relevant to the expenditure cycle. The chapter discussion explores these tests in more detail.	pp. 824–830
D10: What is involved in determining a preliminary audit strategy and planning an audit program for substantive tests for shareholders' equity?	Figure 17-12 outlines one possible preliminary audit strategy for each assertion in the financing cycle for shareholders' equity. This section also uses the framework developed in Chapter 12 to design substantive tests for stockholders' equity. Figure 17-13 focuses on the nature of substantive tests for shareholders' equity. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, and tests of details of disclosures relevant to the expenditure cycle. The chapter discussion explores these tests in more detail.	pp. 831–837
D11: How does the auditor use the knowledge obtained during the audit of the investing and financing cycles to support other assurance services?	Once the auditor has completed an audit of the investing and financing cycle, the auditor should have information that supports an audit opinion as well as recommendations related to improvements in internal controls. In addition, the auditor probably has obtained knowledge that may be relevant to other client services. This final section of the chapter provides examples of how knowledge obtained while auditing the financing and investing cycles can be used to provide other services that client's value.	p. 888

objective questions

Objective questions are available for the student at www.wiley.com/college/boynton

comprehensive questions

17-22 **(Internal controls for plant assets)** Harris, CPA, has accepted an engagement to audit the financial statements of Grant Manufacturing Co., a new client. Grant has an adequate control environment and a reasonable segregation of duties. Harris is about to assess control risk for the assertions related to Grant's property and equipment.

Required

Describe the key internal control structure policies and procedures related to Grant's property, equipment, and related transactions (additions, transfers, major maintenance and repairs, retirements, and dispositions) that Harris may consider in assessing control risk.

AICPA

17-23 **(Audit objectives for plant assets)** Rivers, CPA, is the auditor for a manufacturing company with a balance sheet that includes the caption "Property, Plant & Equipment." The company's management has asked Rivers if audit adjustments or reclassifications are required for the following material items that have been included in or excluded from "Property, Plant & Equipment":

1. A tract of land was acquired during the year. The land is the future site of the client's new headquarters, which will be constructed in the following year. Commissions were paid to the real estate agent used to acquire the land, and expenditures were made to relocate the previous owner's equipment. These commissions and expenditures were expensed and are excluded from "Property, Plant & Equipment."
2. Clearing costs were incurred to make the land ready for construction. These costs were included in "Property, Plant & Equipment."
3. During the land clearing process, timber and gravel were recovered and sold. The proceeds from the sale were recorded as other income and are excluded from "Property, Plant & Equipment."
4. A group of machines was purchased under a royalty agreement that provides royalty payments based on units of production from the machines. The cost of the machines, freight costs, unloading charges, and royalty payments were capitalized and are included in "Property, Plant & Equipment."

Required

a. Identify the audit objectives (assertions) for "Property, Plant & Equipment" and indicate the principal substantive tests pertaining to each.

b. Indicate whether each of the items numbered 1 to 4 above requires one or more audit adjustments or reclassifications, and explain why such adjustments or reclassifications are required or not required. Organize your answers as follows:

Item Number	Is an Audit Adjustment or Reclassification Required? (Yes or No)	Reasons Why Audit Adjustment or Reclassification Is Required or Not Required

AICPA (adapted)

17-24 **(Substantive tests for plant assets)** Pierce, an independent auditor, was engaged to audit the financial statements of Mayfair Construction Incorporated for the year ended December 31, 20X3. Mayfair's financial statements reflect a substantial amount of mobile construction equipment used in the firm's operations. The equipment is accounted for in a subsidiary ledger. Pierce performed a study and evaluation of the internal control structure and found it satisfactory.

Required

Identify the substantive tests that Pierce should utilize in examining mobile construction equipment and related depreciation in Mayfair's financial statements.

AICPA

17-25 **(Substantive tests, assertions, and types of evidence for financing cycle transactions)** The following transactions and events relate to financing cycle transactions in Weber Inc.

1. Declare cash dividend on common stock.
2. Issue bonds.
3. Pay bond interest.
4. Purchase 500 shares of treasury stock.
5. Pay cash dividend declared in (1) above.
6. Issue additional common stock for cash.
7. Accrue bond interest payable at year-end.
8. Redeem outstanding bonds.
9. Establish appropriation for bond retirement.
10. Announce a two-for-one stock split.

Required

a. Identify the substantive test that should verify each transaction or event.

b. For each test, indicate the financial statement assertion(s) to which it pertains.

c. Indicate the type of evidence obtained from the substantive test (i.e., physical, confirmation, documentary, written representation, mathematical, oral, or analytical). Use a tabular format for your answers, with one column for each part.

17-26 **(Substantive tests and disclosures for long-term debt)** Andrews, CPA, has been engaged to audit the financial statements of Broadwall Corporation for the year ended December 31, 20X1. During the year, Broadwall obtained a long-term loan from a local bank pursuant to a financing agreement that provided that the

1. Loan was to be secured by the company's inventory and accounts receivable.
2. Company was to maintain a debt-to-equity ratio not to exceed two to one.
3. Company was not to pay dividends without permission from the bank.
4. Monthly installment payments were to commence July 1, 20X1.

In addition, during the year the company also borrowed, on a short-term basis, from the president of the company, including substantial amounts just prior to the year-end.

Required

a. For purposes of Andrews' audit of the financial statements of Broadwall Corporation, what substantive tests should Andrews employ in examining the described loans? Do not discuss internal control.

b. What are the financial statement disclosures that Andrews should expect to find with respect to the loans from the president?

AICPA

17-27 **(Substantive tests for stockholders' equity balances)** Jones, CPA, the continuing auditor of Sussex, Inc., is beginning the audit of the common stock and treasury stock accounts. Jones has decided to design substantive tests with control risk at the maximum level.

Sussex has no par, no stated value common stock, and acts as its own registrar and transfer agent. During the past year, Sussex both issued and reacquired shares of its own common stock, some of which the company still owned at year-end. Additional common stock transactions occurred among the shareholders during the year.

Common stock transactions can be traced to individual shareholders' accounts in a subsidiary ledger and to a stock certificate book. The company has not paid any cash or stock dividends. There are no other classes of stock, stock rights, warrants, or option plans.

Required

What substantive tests should Jones apply in examining the common stock and treasury stock accounts?

AICPA

17-28 **(Confirmation of stock outstanding)** You are engaged in doing the audit of a corporation whose records you have not previously audited. The corporation has both an independent transfer agent and a registrar for its capital stock. The transfer agent maintains the record of stockholders, and the registrar checks that there is no overissue of stock. Signatures of both are required to validate certificates.

It has been proposed that confirmations be obtained from both the transfer agent and the registrar as to the stock outstanding at the balance sheet date. If such confirmations agree with the books, no additional work is to be performed as to capital stock.

Required

If you agree that obtaining the confirmations as suggested would be sufficient in this case, give the justification for your position. If you do not agree, state specifically all additional steps you would take and explain your reason for taking them.

AICPA

cases

17-29 The Lewis Company is a biotechnology company that has recently received U.S. Food and Drug Administration (FDA) approval for a new drug that treats Parkinson's disease, and sales are showing early signs of success. On the wave of this success, the Lewis Company acquired a patent for a related drug from Brown and Harley, another biotechnology company, that is designed to treat Alzheimer's disease. Brown and Harley has completed successful animal tests with the patented drug known as AZH. Now that Lewis has acquired the patent, Lewis will have to take the drug through human trials and obtain FDA approval, a process that could take two to four years.

Lewis agreed to pay Brown and Harley $10 million for the patent on February 29, 20X0. Brown and Harley's book value associated with the patent was only $500,000. Lewis acquired the patent from Brown and Harley for $1 million in cash and $9 million in 9%, preferred stock redeemable on February 29, 20X4. Lewis accounted for the transaction by debiting an asset account for the patent in the amount of $10 million, with an intent to amortize the patent over 16 years, the remaining legal life of the patent, crediting cash for $1 million, and crediting shareholders' equity accounts for $9 million.

Required

a. What is the economic substance of the patent acquired by the Lewis Company? In your opinion, has the Lewis Company accurately accounted for the investing side of the transaction?

b. Describe the audit procedures that you would perform in 20X0 to audit the patent. For each procedure, describe how the procedure satisfies the audit of management's financial statement assertions.

c. What is the economic substance of the preferred stock issued by the Lewis Company? In your opinion, has the Lewis Company accurately accounted for the financing side of the transaction?

d. Describe the audit procedures that you would perform in 20X0 to audit the preferred stock. For each procedure, describe how the procedure satisfies the audit of management's financial statement assertions.

professional simulations

Situation	Audit Procedures	FARS Research	Audit Report

Your client, Alpha Net Universal (ANU), was founded in 1992. It went public with an IPO in 1998 and it had a very profitable run for the next ten years. ANU's most recent product as been so successful that ANU is planning on expanding the technology into other business and engineering applications and it is looking for new facilities. Russell Craig (ANU's CFO) is very pleased to be looking for real estate in late 20X3 as the local commercial real estate market is depressed and property values are low. Russell feels that if he had to rent in this market he would pay about $15.00 a square foot per year for space that would fit the company's needs. He is close to completing the negotiation of a lease transaction, and he wants to confirm his understanding regarding the accounting for the transaction. Russell expects that if ANU goes forward with the lease, it will close on December 31, 20X3.

Situation	Audit Procedures	FARS Research	Audit Report

Exhibit 17-30 provides a working paper (lead schedule) for the audit of ANU's property, plant and equipment. Explain the auditing procedures that should be performed associated with the legend identified as a) through h). Use the following format.

Legend	Audit Procedure
a)	
b)	
c)	
d)	
e)	
f)	
g)	
h)	

EXHIBIT 17-30 PLANT ASSET AND ACCUMULATED DEPRECIATION LEAD SCHEDULE

Alpha Net Universal
Property Plant and Equipment and Accumulated Depreciation
Lead Schedule
December 31, 21X3

W/P Ref: **G**
Prepared by: *CJG* Date: 2/4/X4
Reviewed By: *RCP* Date: 2/12/X4

Account Title Asset Cost	Balance 112/31/x2	Additions	Disposals	Adjustments Dr (Cr)	Balance 12/31/X3
Land	$ 550,000 c)	$ 50,000 d)		$ (25,000) f)	$ 575,000
Buildings	$ 2,150,000 c)	$ 250,000 d)		$ 25,000 f)	$ 2,425,000
Machinery and Equipment	$ 3,650,000 c)	$ 945,000 d)	$ 365,000 e)		$ 4,230,000
Furniture and Fixtures	$ 825,000 c)	$ 123,000 d)	$ 55,000 e)		$ 893,000
Capital Leases	$ 1,175,000 c)				$ 1,175,000
Total	$ 8,350,000	$ 1,368,000	$ 420,000	$ —	$ 9,298,000
	a)	a)	a)	a)	b)

Accumulated Depreciation	Balance 112/31/x2	Provisions	Disposals	Adjustments Dr (Cr)	Balance 12/31/X3
Land	$ — c)				$ —
Buildings	$ 380,000 c)	$ 85,000 g)			$ 465,000
Machinery and Equipment	$ 1,075,000 c)	$ 352,800 g)	$ 171,250 h)		$ 1,256,550
Furniture and Fixtures	$ 212,250 c)	$ 123,000 g)	$ 23,000 h)		$ 312,250
Capital Leases	$ 470,000 c)	$ 117,500 g)			$ 587,500
Total	$ 2,137,250	$ 678,300	$ 194,250	$ —	$ 2,621,300
	a)	a)	a)	a)	b)

Situation	Audit Procedures	FARS Research	Audit Report

A real estate development company, Shailer Construction, has recently completed construction of a 35,000 square foot facility that would fit ANU's needs. The fair market value of the land and buildings is currently $10 million. ANU and Shailer Construction have found permanent funding for the transaction from a major commercial bank, Portland Commercial Bank (PCB). Following is a summary of the key aspects of the transaction.

- Shailer Enterprises, a special purpose entity, will purchase the completed building from Shailer Construction for $10 million. Shailer Enterprises will be funded with $1 million in equity provided by Shailer Construction, and $9 million in a loan from PCB (based on the investment grade credit rating of the lessee, ANU). PCB will lend the $9 million to Shailer Enterprises at a floating interest rate of the prime rate plus one percent. Shailer will pay interest only on the loan until it comes due in six years on December 31, 20X9; however, PCB will consider renewing the loan for another six-year period based on the economic circumstances at the time.
- ANU will lease the property from Shailer Enterprises in a noncancelable lease that expires on December 31, 20X9. ANU will be committed to a fixed monthly payment amounting to $10,000 plus a variable lease component amounting to the prime rate plus one percent on the $9 million principal of the loan.

- ANU will agree to pay all the cost of operation of the facility, including leasehold improvements, utilities, insurance, property taxes, and any other operating costs. In addition, ANU is responsible for any risks due to environmental conditions that may be created during the term of the lease, damage, or destruction. ANU has full responsibility to manage, maintain, and operate the property.
- At the end of the lease (December 31, 20X9), ANU will have three options.
  1. ANU can elect to extend the term of the lease, subject to ANU's credit standing, and ANU's ability to extend or restructure the debt and equity transactions with Shailer and lenders.
  2. ANU can purchase the property for $10 million. If the $10 million price is so significantly below market value that is deemed to be a bargain purchase, then ANU agrees to pay an additional amount to Shailer Enterprises, agreed upon by both parties, so that it will not be a bargain purchase.
  3. If ANU does not extend the lease term or purchase the property, it must vacate the property, and make a contingent rent payment that is capped in the amount of $5 million that will be used to retire the principal on the loan. ANU, as an agent of Shailer Enterprises, is responsible for finding a third party to purchase the property and ANU will bear all the costs of the sale. Once the property is sold, the proceeds will be used to (1) retire the remaining principal and interest due on the loan, and (2) pay Shailer Enterprises $1 million. The remainder of the proceeds will go to ANU.
- ANU will also agree to a lease covenant that it will maintain $5 million in long-term investments as security for any potential contingent rent that may be due at the end of the lease. These funds will be invested in government securities and managed and held in safekeeping by PCB.

Russell Craig wants you to confirm his understanding that under SFAS #13 and EITF 90-15 this is an operating lease. He plans to record lease payments as an expense along with other operating costs of the facility. Furthermore, he plans to disclose all the normal disclosures associated with operating lease, and he further will disclose the related restrictions on the $5 million of long-term investments. Cut and paste all appropriate sections of accounting standards that apply to the accounting for the lease that Mr. Craig is considering.

Situation	Audit Procedures	FARS Research	Audit Report

Draft the audit opinion that you would write if ANU accounts for this lease as proposed by Mr. Craig.