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Fixed Asset Controls and Reporting: Who's Paying Attention To Your Largest Assets?

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Often an element of fraud and financial misstatement, fixed assets get no respect. Although they're considered low risk by auditors, fixed assets need attention. Are the internal controls really effective over this perceived low-risk area? Best practices enhance proper accounting, valuations and financial reporting.

Are you confident your fixed assets are accurately represented in your organization's year-end financial statements? In many cases, your answer will be "Yes." However, audits may yield a different answer. While many organizations never perform an inventory of current fixed assets and corresponding reconciliation, these tasks provide an essential internal control for the financial reporting of fixed assets.

The historical cost of property, plant, and equipment and the related accumulated depreciation are reported in the financial statements. However, historical audit procedures focused on the current-year acquisition of fixed assets and the reporting of the net book value of the aggregate investment in fixed assets. These procedures fail to address that most organizations have very poor controls over the disposal of fixed assets. Although this approach may result in a fair representation of the net book value of property, plant and equipment (PP&E), it has generally led to the overstatement of both the historical cost of PP&E and the related accumulated depreciation.

Fixed assets represent the long-term tangible assets an organization utilizes to produce and deliver its products or services and manage its operations. In many capital-intensive industries, fixed assets represent the largest item on the balance sheet. However, fixed assets have historically received little audit scrutiny. As a result, some major financial frauds have been perpetrated through significant misstatements of fixed asset balances in the financial statements of public companies.

The typical audit approach

Fixed assets are probably one of the simplest and most repetitive areas of accounting. Prior to the passage of the Sarbanes-Oxley Act (SOX), auditors viewed fixed assets as having the appropriate internal controls and, therefore, deemed them a low-risk area. Audits of fixed assets were allocated little time, and were usually assigned to an entry-level staff auditor. Fixed asset audit procedures were limited to:

- Reviewing a rollforward analysis for the cost and depreciation account balances
- Vouching of current-year purchases
- Reasonableness testing of current-year depreciation expense calculations
- Performing very limited reconciliation procedures

Back then, this approach was well understood by the external audit profession, their clients' accounting managers, corporate controllers and chief financial officers.

What changed? The credibility of the financial reporting of publicly owned companies was significantly damaged by corporate scandals, beginning when a number of major corporations collapsed in late 2001 and early 2002. Investor confidence was severely eroded, and Congress enacted SOX.

Central to SOX is the increased testing of internal controls. Another noteworthy requirement is that publicly owned companies maintain an internal audit function. The increased testing of internal controls, coupled with the required role of internal auditors, has led to increased scrutiny of fixed assets.

Controls over fixed assets

Fixed asset transactions typically represent the acquisition and disposal of assets and the allocation of related costs to reporting periods through depreciation expense. Internal controls over the acquisition of fixed assets are straightforward, easy to test and include the following:

- Issuance and approval of a purchase order
- Receipt of assets and preparation of a receiving report
- Receipt of the vendor invoice
- Reconciliation of the vendor invoice to the related receiving report and purchase order
- Authorization of the payment of the vendor invoice
- Issuance of a check for payment of the vendor invoice
- Posting the entry in the equipment subledger
- Posting the equipment subledger activity to the related general ledger control accounts
- Reconciliation of the general ledger control accounts to the equipment subledger

However, in a number of other fixed asset transactions, internal controls are not typically addressed. These include the following:

- Inadequate asset descriptions including missing manufacturer, model and serial number information
- Bulk purchases of equipment
- Little or no use of property identification tags
- Inconsistent application of the capitalization threshold
- Construction-in-progress projects not properly segregated into building and equipment accounts
- Poor documentation of asset movement including disposal activity and transfers
- Assignment of unreasonable lives for depreciation calculations
- Infrequent or no periodic physical inventory/reconciliation

Not as low risk as you think

The fixed asset accounting records of an organization have far-reaching effects. As noted earlier, depending on the type of institution, fixed assets can represent the largest item on the balance sheet. Therefore, deficient fixed asset records can lead to inaccurate financial reporting…and inaccurate financial reporting can lead to a qualified audit opinion, which can damage management's credibility with shareholders, lenders and suppliers.

Depending on the city and state in which it resides, a company can be subject to personal property tax. Tax assessments are typically based on the fixed asset accounting records, with rates applied to the assessed value. Unfortunately, it is not uncommon for organizations to be overpaying taxes by 10% to 20%, because of assets that no longer exist but are still on the books.

Similarly, fixed asset accounting records are used to determine the replacement cost of personal property for insurance placement purposes. When it comes to insurable values, accuracy is critical—especially if a loss has occurred.

Organizations routinely use the net book value of existing fixed asset accounting records to assist in negotiations when acquiring entities. The net book value of the fixed assets may serve as a proxy for their fair value. Therefore, it is critical for the acquiring entity to employ the appropriate due diligence to make sure it is getting the assets it is paying for.

Auditors still believe fixed assets to be low risk. In view of the high-profile fraud cases, the personal property tax and insurance implications, and the impact on purchase price allocations, this is a bit surprising.

While organizations should not be alarmed, they should understand the implications of not maintaining accurate fixed asset accounting records. The ability to maintain accurate records can be very challenging for organizations, especially those that are large, capital intensive and decentralized. Two solutions are available: diagnostic consulting, and fixed asset inventory and reconciliation.

How effective are your controls?

Typically, organizations maintain written policies and procedures for purchasing capital assets – but are these policies effective, and does the organization adhere to them? In many cases, the same procedures have been in place for years, without updates to reflect changes in the business, regulations and economy. Sometimes, procedures are updated but not practiced effectively.

Regardless of the type of business, it is important to have effective policies and to review them periodically to ensure their continued effectiveness and practicality. Equally important is following policy. Organizations with concerns in this area can engage an external consultant to assess and recommend improvements.

These engagements typically begin with a thorough analysis of existing policies and procedures as well as interviewing staff members responsible for asset life cycles (acquisition to disposition). Recommendations are made to senior management regarding identified weaknesses, and implicated policies and procedures can be modified or rewritten. The result will be a best-practice approach to asset management.

Button, button, who's got the button?

Even when an organization has good procedures in place, equipment tends to be moved, transferred and disposed of without proper documentation. Therefore, it is important to conduct a periodic fixed asset inventory, followed by reconciling the inventory to the fixed asset accounting records.

Many organizations attempt to perform this in-house, which poses challenges. Lack of experience, poor descriptions on the fixed asset accounting records and allocating the appropriate amount of time are just a few of the challenges.

In addition, in-house inventories are usually conducted by the custodians of the equipment, who may be hesitant to report unrecorded retirements. For instance, who wants to report that their respective area is part of the reason for a personal property tax overstatement? Independence and objectivity are casualties of an in-house inventory and reconciliation. Lack of objectivity is the most significant concern expressed by management regarding employees performing the physical inventory.

Therefore, you should select an independent firm that has both specific industry and physical inventory and reconciliation qualifications and experience. Firm staff should understand the organization of institutions, be familiar with all types fixed assets, and understand the protocol for operating in unique environments and interacting with professionals and staff.

What are best practices?

Conduct an inventory at least once every five years, selecting an independent firm with:

- Specific industry and qualifications and experience
- Physical inventory and reconciliation expertise, including performing a detailed line by line reconciliation of the physical inventory to the fixed asset accounting records

Affix property tags to all untagged assets.

Consistently apply the capitalization threshold while conducting the inventory.

Record all descriptive and locational information possible.

Complete the inventory as quickly as possible to minimize asset movement.

The reconciliation process

If the right steps are followed, a comprehensive inventory can be completed simply and painlessly.

Reconciliation can be an entirely different experience, but various approaches can help organizations simplify this process. Briefly, the reconciliation process will identify the following:

- **Matched assets** – items found during the inventory process and traced to the fixed asset accounting records
- **Unrecorded additions** – items found during the inventory process but not found in the fixed asset accounting records
- **Unrecorded retirements** – items found in the fixed asset accounting records but not found during the inventory process

The approaches to reconciliation can be broken into three categories: tag number match, hybrid reconciliation and comprehensive line-by-line reconciliation. Depending on the approach, the number of assets and the associated historical cost of the matches, retirements and additions will vary significantly.

Tag number

By definition, the tag number match is the comparison of existing tag numbers to those found in the fixed asset accounts. The tag number is the primary mechanism for identifying a fixed asset. In many cases, this can result in a 50% or less match rate, and the auditors will have difficulty accepting the credibility of the inventory process because of the large variances.

Hybrid

The hybrid reconciliation takes the tag number approach a step further. Going beyond the tag number match, additional effort is made to address matches by description, manufacturer, model and serial number that appear in the rest of the record. If the quality of the fixed asset accounting records is very good, this approach may yield acceptable results. However, many organizations' fixed asset accounting records are of poor quality, and this approach may not yield completely acceptable results.

Line by line

The comprehensive line-by-line reconciliation is considered a best-practice approach. This approach goes beyond hybrid reconciliation to address each asset until it is verified as a match, retirement or addition. It involves the following steps:

- Tag number matches are addressed first.
- Manufacturers and models are compared.
- Additional description, location and department numbers are considered.
- Fiscal year additions are analyzed against estimated acquisition dates from the inventory.
- Bulk purchase entries and grouped purchases are allocated to the individual assets (computer equipment, furniture, manufacturing equipment, etc.).
- Follow-up visits with departments are conducted to verify any residual assets.

Regardless of approach, a consistent audit trail should be used to link the reconciled inventory file with the existing fixed asset accounting records. It is important to assign a transaction code in order to establish an audit trail on each item. The transaction code identifies the actual disposition of each asset.

Simple transaction codes are:

- "A" – Unrecorded addition
- "M" – Matched asset
- "R" – Unrecorded retirement

Each line item on the fixed asset accounting record will receive a transaction code to link it to the reconciled inventory file.

Independence and objectivity are critical in any audit, so it may be desirable to hire a consultant to assist with this process. You should only consider firms that have:

- Specific industry qualifications and experience
- Extensive experience working with the Big Four and other public accounting firms
- The latest technology, including accounting software that is audited annually, so that proper depreciation calculations are made
- The ability to perform comprehensive line by line reconciliation of the physical inventory to the accounting records that will withstand audit scrutiny

In addition, the firm should be able to provide appropriate references.

Conclusion

Fixed asset inventory and reconciliation procedures can help an organization withstand today's increased level of fixed asset scrutiny. For many organizations, fixed assets represent the largest item on the balance sheet. To ensure proper valuation of these assets and accurate financial reporting, organizations need to confirm the proper handling of these transactions. Internal auditors can add value by ensuring their management gives an appropriate amount of attention to this area.

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