

INCREASED
SCRUTINY

FIXED ASSET CONTROLS AND REPORTING

By Mark Bobber

Although they're considered low risk by auditors, fixed assets need attention to ensure the organization's records are accurate and its controls provide effective oversight of this area. As with other asset classes, best practices enhance proper accounting, valuations and financial reporting.

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

When asked if fixed assets are represented accurately in year-end financial statements, most organizations will answer with "yes." However, audits

may yield a different answer. Although many organizations do not perform an inventory of current fixed assets and a corresponding reconciliation, these steps provide an essential internal control for the financial reporting of fixed assets.

Typical Audit Approach

Fixed assets are probably one of the simplest and most repetitive areas of accounting. Before 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 usually assigned to an entry-level staff auditor.

Fixed asset audit procedures were typically limited to:

- Reviewing a roll-forward analysis for the cost and depreciation of account balances
- Vouching of current-year purchases
- Reasonableness testing of current-year depreci-



Often an element of fraud and financial misstatement, fixed assets get no respect.



ation expense calculations

- Performing very limited reconciliation procedures

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

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

One of SOX's central components is the increased testing of internal controls. Another noteworthy requirement is that publicly owned companies maintain an internal audit

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function. This 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. The 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 an invoice from a vendor
- 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 of the entry in the equipment subledger
- Posting of the equipment subledger activity to the related general ledger control accounts
- Reconciliation of the general ledger control accounts to the equipment subledger

However, for a number of other fixed-asset transactions, internal controls are not typically addressed. Resulting missteps often include:

- Inadequate asset descriptions including missing manufacturer, model and serial number information
- Little or no use of property identification tags

- Inconsistent application of the capitalization threshold
- Improper segregation of construction-in-progress projects into building and equipment accounts
- Poor documentation of asset movement including disposal activity and transfers
- Assignment of unreasonable asset lives for depreciation calculations
- Infrequent (or not performing) physical inventory/reconciliation

Not as Low-Risk as Perceived

The fixed-asset accounting records of an organization have more far-reaching effects than they are typically given credit for. As noted earlier, and 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 in turn can damage management's credibility with shareholders, lenders and suppliers.

Depending on the city and state in which it operates, a company can be subject to personal property tax. Tax assessments are typically based on the organization's fixed-asset accounting records, with rates applied to the assessed value. Unfortunately, it is not uncommon for organizations to overpay taxes by 10 percent to 20 percent because of assets that no longer exist but are still on the books (see example below).

Each state differs in how personal property tax rates are set. In this example, a state that assesses personal property tax at 1/3 of the fair market value is used. It's important to note that each assessed asset, regardless of age or condition, will have a residual value. This residual value can be as high as 30 percent of the original purchase price, and it will continue as long as the asset remains active within the fixed-asset accounting records.

As mentioned, 10 percent to 20 percent of an organization's fixed assets may no longer exist (these are often termed "ghost assets"), and can easily equate to approximately 10 percent to 20 percent of the historical cost. Assume that Company X has ghost assets equal to approximately 15 percent of their historical cost balance — these assets are old and have a fair market value (residual) equal to 20 percent of their historical cost, and their as-

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essed value is 1/3 of their fair market value. The tax implications are illustrated as follows:

- Company X's fixed asset historical cost balance - \$50 million
- Approximate historical cost of ghost assets - \$7.5 million
- Estimated fair market value of ghost assets - \$1.5 million
- Assessed value of ghost assets - \$500,000

It is often assumed that all ghost assets are old and carry the minimum residual value, but in reality the fair market value, and therefore the assessed value, is usually higher. A reduction in overall assessed value can produce an immediate cash savings.

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 important — 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 the final purchase price. 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.

Despite situations similar to the preceding example, many auditors still believe fixed assets to be low risk. This is a bit surprising in view of high-profile fraud cases, the personal property tax and insurance implications, and the impact on purchase price allocations.

While organizations should not be alarmed, it's important to 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

Key best-practice components:

- Conduct an inventory every five years
- The inventory team should be independent and not have a vested interest in the results
- Consistently apply the capitalization threshold of the organization while conducting the inventory
- Complete the inventory as quickly as possible to minimize asset movement
- Record all descriptive and locational information possible
- Affix property tags to all untagged assets.

How Effective Are Controls?

Organizations typically maintain written policies and procedures for purchasing capital assets; the question becomes whether these policies are effective and whether they are practiced. In many cases, the same procedures have been in place for years and have not been updated to reflect changes in the business, regulations and economy. Sometimes, the procedures have been updated, but they are not practiced as effectively as they should be.

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 that have concerns in this area can engage an external consultant to perform an assessment and recommend improvements.

Such a consulting engagement typically begins with a thorough analysis of existing policies and procedures as well as interviews of staff members responsible for asset life cycles (acquisition to disposition). Recommendations are made to senior management regarding identified weaknesses, and the 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's important to conduct a periodic fixed-asset inventory.

An important step is reconciling the inventory to the fixed-asset accounting records. Many organizations attempt to perform this in-house, which can pose challenges. Lack of experience, poor descriptions on the accounting records and allocating the appropriate amount of time are just a few of the challenges.

In-house inventories are conducted by the custodians of the equipment, who may be afraid of reporting 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 common casualties of an in-house inventory and reconciliation.

The Reconciliation Process

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

The reconciliation process can be an entirely different experience. There are various approaches to completing this

step. In most instances, 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 that are found during the inventory process but not found in the fixed-asset accounting records
- Unrecorded retirements — items that are found in the fixed-asset accounting records but not found during the inventory process

There are several approaches to reconciliation, which 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.

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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 approach can result in a 50 percent or lower 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. 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

A 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 taken into consideration
- Fiscal year additions are analyzed against estimated acquisition dates from the inventory
- Bulk 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 which approach is used, 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 to establish an audit trail on each item. The transaction code identifies the actual disposition of each asset. Simple transaction codes are:

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. Organizations should only consider consulting firms with specific industry expertise and those who work extensively with the Big Four and other public accounting firms. Consultants should be able to provide appropriate references. They should also use the latest technology, including accounting software that is in compliance with SOC 1, so proper depreciation calculations are made.

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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