

CHAPTER-FIVE

AUDIT OF FIXED ASSETS

- Property, plant, and equipment are assets that have expected lives of **more than one year**, are used in the business, and are not acquired for resale.
- The intent to use the assets as **part of the operation of the client's business** and their expected lives of more than one year are the significant characteristics that distinguish these assets from **inventory, prepaid expenses, and investments**.

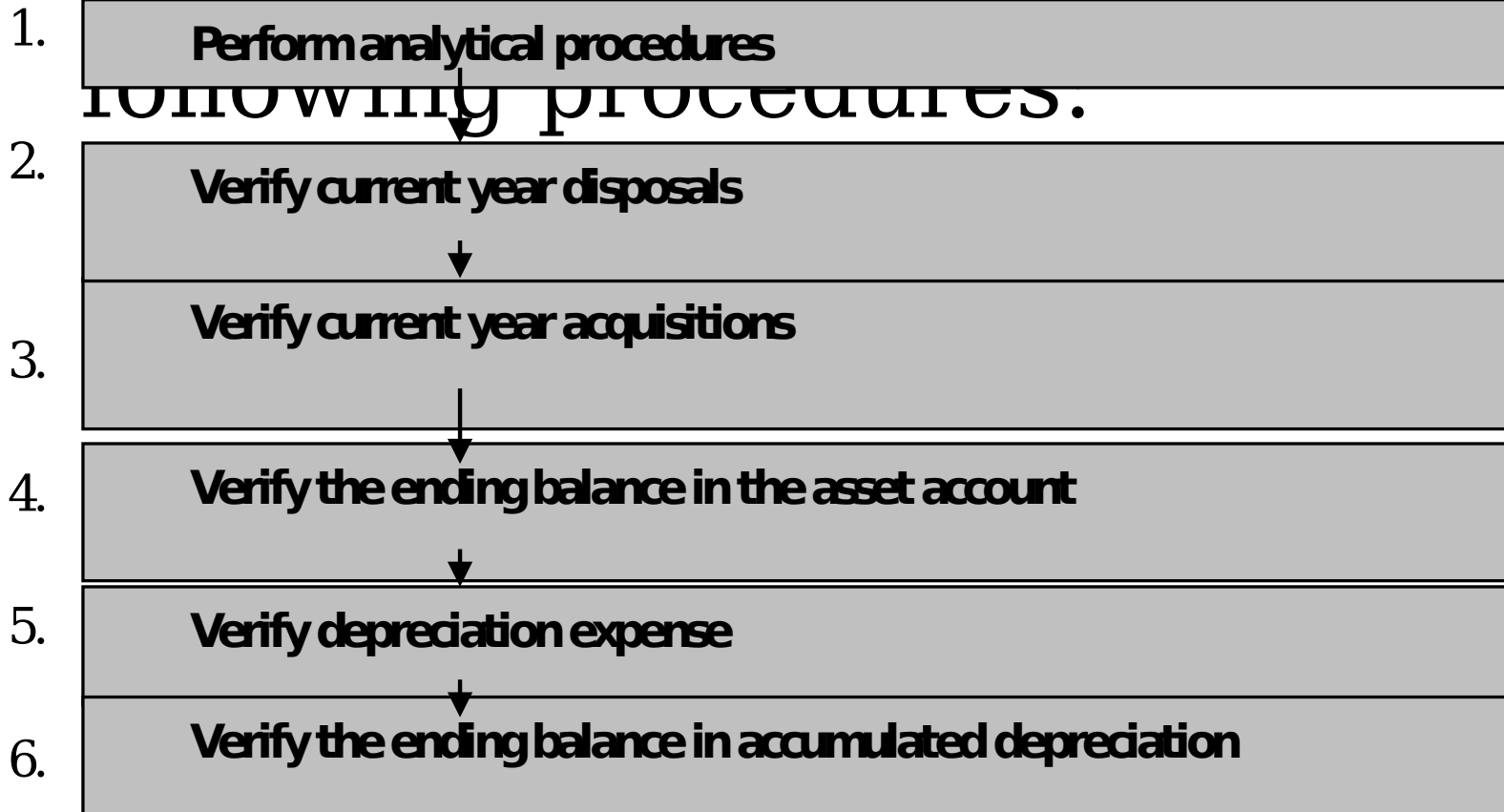
- ❖ The acquisition of property, plant, and equipment occurs through the **acquisition and payment cycle.**
- ❖ Because the audits of property, plant, and equipment accounts are similar.
- ❖ Debits to equipment arise from the acquisition and payment cycle.

- Because the source of debits in the asset account is the **acquisitions journal**, the accounting system has normally already been tested for recording current period additions to equipment as part of the tests of the **acquisition** and **payment cycle**.
- However, because equipment additions are infrequent, often for large amounts, and subject to special controls, such as board of directors' approval the auditor may decide not to

- ❖ The primary accounting record for equipment and other property, plant, and equipment accounts is generally a **fixed asset master file**.
- ❖ The master file includes a detailed record for each piece of equipment and other types of property owned.
- ❖ Each record in the file includes a **description of the asset, date of acquisition, original cost, current year depreciation, and accumulated**

- The totals for all records in the **master file** equal the general ledger balances for the related accounts: equipment, depreciation expense, and accumulated depreciation.
- The master file also contains information about **property acquired** and **disposed** of during the year.

- In the audit of equipment and related accounts, it is helpful to separate the tests in to the



- As in all audit areas, the type of analytical procedures depends on the nature of the client's operations.
- Most of the typical analytical procedures assess the likelihood of material misstatements in depreciation expense and accumulated depreciation.

- Companies must correctly record **current year additions** because the assets have long term effects on the financial statements.
- The failure to **capitalize a fixed asset**, or the recording of an acquisition at the incorrect amount, affects the balance sheet until the company disposes of the asset.
- The income statement is affected until the asset is fully **depreciated**.

- The starting point for the verification of current year acquisitions is normally a **schedule obtained** from the client of all acquisitions recorded in the **general ledger of property, plant, and equipment accounts** during the year.
- The client obtains this information from the **property master file**.
- A typical schedule lists each addition separately and includes the date of the **acquisition, vendor, description, notation of whether it is new or used, life of the asset for depreciation purposes, depreciation method, and cost**.

- ❖ Notice that the most **common audit test to verify additions** is to examine vendors' invoices.
- ❖ Additional testing, beyond that which is done as part of the **tests of controls and substantive tests** of transactions, is often necessary because of the complexity of many equipment transactions and the materiality of the

- ❑ It is normal for auditors to verify **large and unusual transactions** for the entire year as well as a representative sample of typical additions.
- ❑ The extent of testing depends on the auditor's assessed control risk for acquisitions and the materiality of the additions.
- ❑ In **testing acquisitions**, the auditor must understand accounting standards to make certain the client follows the related requirements.

For example, the auditor needs to be alert for the possibility of the client's failure to include material transportation and installation costs as part of the asset's acquisition cost and the failure to properly record the trade-in of existing equipment.

- The auditor also needs to know the client's capitalization policies to determine whether acquisitions are treated consistently with those of the preceding year.
- For example, if the client's policy is to automatically **expense acquisitions** that are less than a certain amount, such as \$1,000,

- ❖ Auditors should also verify recorded transactions for correct classification among various **equipment accounts**.
- ❖ In some cases, amounts recorded as manufacturing equipment should be classified as office equipment or as a part of the building.
- ❖ It is also possible the client has incorrectly capitalized repairs, rents or similar expenses.

➤ Poor internal controls over document preparation can result in significant misclassifications of disbursement transactions.

➤ Clients commonly include transactions that should be recorded as assets in repairs and maintenance expense, lease expense, supplies, small tools and similar accounts

- ✓ The misstatement may result from a **lack of understanding accounting standards** or from **clients' desires** to **avoid income taxes.**
- ✓ If auditors conclude this type of material misstatement is likely, they may need to **vouch larger** amounts debited to the expense accounts.
- ✓ It is a common practice to do so as part of the audit of the property, plant, and equipment accounts.
- ✓ Auditors also need to examine whether the client **has a right to record equipment as an asset.**

- Some large manufacturing equipment and other types of machinery, such as sophisticated medical equipment or computer data center equipment, may be under an operating lease.
- Auditors frequently examine purchase or lease contracts to determine whether capitalization of the equipment is appropriate.

- Transactions involving the disposal of equipment are often misstated when company internal controls **lack a formal method to inform management of the sale, trade-in, abandonment, or theft of recorded machinery and equipment.**
- If the client fails to record disposals, the original cost of the equipment account will be overstated indefinitely, and net book value will be overstated until

- ❖ Formal methods of tracking disposals and provisions for proper authorization of the sale or other disposal of equipment help reduce the risk of misstatement.
- ❖ There should also be adequate internal verification of recorded disposals to make sure that assets are correctly **removed** from the accounting records.
- ❖ The auditor's main objectives in the verification of the sale, trade-in, or

- The starting point for verifying disposals is the **client's schedule** of recorded disposals.
- The schedule typically includes the date when the asset was disposed off, name of the person or firm acquiring the asset, selling price, original cost, acquisition date, and

The following procedures are often used for verifying disposals:

- ❖ Review whether **newly acquired assets** replace **existing assets**
- ❖ Analyze **gains and losses** on the disposal of assets and miscellaneous income for receipts from the disposal of assets
- ❖ Review **plant modifications** and changes in product line, changes in major costly computer-related equipment, property taxes, or insurance coverage for indications of **deletions** of equipment
- ❖ Make **inquiries of management** and **production personnel** about the possibility of the **disposal of assets**

- When an asset is sold or disposed of without having been traded in for a replacement asset, the ***accuracy*** of the transaction can be verified by examining the related **sales invoice and property master file**.
- The auditor should compare the **cost** and **accumulated depreciation** in the master file with the recorded entry in the general journal and recomputed the **gain or loss** on the disposal of the asset for comparison with the accounting records.

- When *trade-in of an asset for a replacement* occurs, the auditor should be sure that the **new asset is capitalized** and the **replaced asset correctly eliminated** from the records, considering the book value of the asset traded in and the additional cost of the new asset.

Two of the **auditor's objectives** when auditing the ending balance in the equipment accounts include determining that:

1) All recorded equipment **physically exists** on the balance sheet date (existence)

2) All equipment owned is

- When designing audit tests to meet these objectives, auditors first consider the nature of **internal controls over equipment**.
- Ideally, auditors are able to conclude that controls are sufficiently strong to allow them to rely on **balances carried** forward from the prior year.
- Important controls include the use of a **master file** for individual **fixed assets**, **adequate physical controls** over assets that are easily movable (such as computers, tools, and vehicles), assignment of identification numbers to each plant asset, and periodic

- Typically, the first audit step concerns the detail tie-in objective: Equipment, as listed in the master file, agrees with the general ledger.
- Examining a printout of the master file that totals to the general ledger balance is ordinarily sufficient.

- ❖ After assessing **control risk** for the existence objective, the auditor decides whether it is necessary to verify the existence of **individual items** of equipment included in the master file.
- ❖ If there is a high likelihood of a material amount of **missing fixed assets** still included in the master file, the auditor can select a sample from the master file and examine the **actual assets**.

- Similarly, based on the auditor's assessment of control risk for the completeness objective, the auditor may **physically examine a sample** of major equipment items and trace them to the master file.
- In rare cases, the auditor may decide it is necessary for the client to take a complete **physical inventory of fixed assets** to make sure they all exist, and the fixed asset records are complete.
- If a physical inventory is taken, the auditor normally observes the count.

- The ***proper presentation and disclosure*** of equipment in the financial statements must be evaluated carefully to make sure that accounting standards are followed.
- Equipment should include the **gross cost** and should ordinarily be separated from **other fixed assets**.
- **Leased property** should also

- **Depreciation expense** is one of the few expense accounts not verified as part of tests of controls and substantive tests of transactions.
- The recorded amounts are determined by ***internal allocations*** rather than by exchange transactions with outside parties.
- When depreciation expense is **material**, more tests of details of depreciation expense are required

- The most important balance-related audit objective for depreciation expense is accuracy.
- Auditors focus on determining whether the client followed a **consistent depreciation policy** from period to period, and the client's **calculations are correct.** In determining the former, auditors must weigh four considerations:

➤ **The useful life of current period acquisitions**

➤ **The method of depreciation**

5.2 Audit of prepaid expenses

- Prepaid expenses, deferred charges, and intangibles are assets that vary in life from several months to several years. These include:

Prepaid rent

Patents

Deferred charges

Organization costs

Prepaid insurance

Copyrights

Prepaid taxes

Trademarks

- In some cases, these accounts are highly material.
- However, in a typical audit, the company does not have many of the accounts listed or they are immaterial.
- Analytical procedures are often sufficient for prepaid expenses, deferred charges, and intangibles

- Prepaid insurance and the acquisition and payment cycle are related through the debits to the prepaid insurance account.
- Because the source of the debits in the asset account is the **acquisitions journal**, the payments of insurance premiums have already been partially tested by means of the tests of controls and substantive tests of acquisition and cash disbursement transactions.

- Internal controls for prepaid insurance and insurance expense can be conveniently divided into three categories: controls over the acquisition and recording of insurance, controls over the insurance register, and controls over the charge-off of insurance expense.
- An **insurance register** is a record of insurance policies in

- In the audit of prepaid insurance, the auditor obtains a schedule from the client that lists for each policy in force:
 - Policy information, including policy number, amount of coverage and annual premium
 - Beginning prepaid insurance balance
 - Payment of policy premiums
 - Amount charged to insurance expense
 - Ending prepaid insurance balance

Auditors commonly perform the following analytical procedures for **prepaid insurance** and insurance expense:

- Compare total prepaid insurance and insurance expense with previous years.
- Compute the ratio of prepaid insurance to insurance expense and compare it with previous years.
- Compare the individual insurance policy coverage on the schedule of insurance obtained from the client with the preceding year's schedule as a test of the elimination of certain policies or a change in insurance coverage.

- Compare the computed prepaid insurance balance for the current year on a policy by policy basis with that of the preceding year as a test of an error in calculation.
- Review the *insurance coverage* listed on the prepaid insurance schedule with an appropriate client official or insurance broker for adequacy of coverage.
- The auditor *cannot be an expert on insurance* matters, but the auditor's understanding of accounting and the valuation of assets is necessary to make sure that a company is not underinsured.

- Our discussion of these tests uses the balance-related audit objectives for performing tests of details of asset balances.
- ❖ **Insurance Policies in the Prepaid Insurance Schedule Exist and Existing Policies Are Listed (Existence and Completeness)**
- ❖ **The Client Has Rights to All Insurance Policies in the Prepaid Insurance Schedule (Rights over insurance)**
- ❖ **Prepaid Amounts on the Schedule Are Accurate and the Total Is Correctly Added and Agrees with the General Ledger (Accuracy and Detail Tie-in)**
- ❖ **The Insurance Expense Related to Prepaid Insurance Is Correctly Classified (Classification)**
- ❖ **Insurance Transactions are recorded in the Correct Period**

5.3 Audit of accrued liabilities

- A third major category of accounts in the acquisition and payment cycle is **accrued liabilities**, which are the estimated unpaid obligations for services or benefits that have been received before the balance sheet date.
- Many accrued liabilities represent future obligations for unpaid services resulting from the passage of time but are not payable at the balance sheet date.

- For example, the **benefits of property rental accrue** throughout the year. Therefore, at the balance sheet date, a certain portion of the total rent cost that has not been paid should be accrued. Other similar liabilities include:

- o Accrued payroll
- o Accrued professional fees
- o Accrued payroll taxes
- o Accrued rent
- o Accrued officers' bonuses
- o Accrued interest
- o Accrued commissions

The verification of accrued expenses varies depending on the nature of the accrual and the circumstances of the client.

5.4 Audit of Income and Expense Accounts

- The auditor must be satisfied that each of the **income and expense totals** included in the income statement, as well as net earnings, are not materially misstated.
- The auditor needs to be aware that most users of financial statements rely more heavily on the **income statement** than on the balance

- Equity investors, long-term creditors, union representatives, and even short-term creditors are more interested in the ability of a firm to generate **profit** than in the **historical cost or book value of the individual assets.**

The following two concepts in the audit of **income and expense** accounts are essential when considering the purposes of the income statement:

- The matching of **periodic income** and **expense** is necessary for a correct determination of operating results.
- The consistent application of

- Both of these concepts must be applied to the recording of individual transactions and to the combining of accounts in the general ledger for statement presentation. The parts of the audit directly affecting these accounts are:

- ✓ Analytical procedures
- ✓ Tests of controls and substantive

- Our emphasis here is on income and expense accounts directly related to the **acquisition and payment cycle**, but the same concepts apply to the income statement accounts in all other cycles.
- **Analytical procedures** should be thought of as part of the test of the fairness of the **presentation of both balance sheet and income statement accounts**.

- Both tests of controls and substantive tests of transactions have the effect of simultaneously verifying **balance sheet and income statement accounts.**
- Inadequate controls and misstatements discovered through tests of controls and substantive tests of transactions indicate the likelihood of **misstatements in both the income statement and the balance sheet.**

- The most important means of verifying many of the income statement accounts in each transaction cycle are understanding **internal control and the related tests of controls and substantive tests** of transactions.
- However, certain income and expense accounts are not verified at all by tests of controls and

- **Expense account analysis** involves auditor examination of underlying documentation of individual transactions and amounts making up the detail of the total of an expense account.
- The documents are the same type as those used for examining transactions as part of tests of acquisition transactions, including invoices, receiving reports, purchase orders, and contracts.
- Although the focus of **expense account analysis is on transactions**, these tests differ from tests of controls and substantive tests of transactions.

- Assuming **satisfactory results** are found in tests of controls and substantive tests of transactions, auditors normally restrict expense analysis to those accounts with a relatively **high likelihood of material misstatement.**

As examples, auditors often analyze:

- **Repairs and maintenance expense** accounts to determine whether they erroneously include property, plant, and equipment transactions
- **Rent and lease expenses** to determine the need to capitalize leases
- **Legal expense** to determine whether there are potential contingent liabilities, disputes, illegal acts, or other legal issues that may affect the financial statements Utilities, travel expense, and advertising accounts are rarely analyzed unless analytical procedures indicate high potential for material misstatement.

- Auditors often analyze **expense account transactions** as part of the verification of a related asset.
- It is common, for example, for auditors to analyze **repairs and maintenance** as part of verifying fixed assets and insurance expense as part of testing prepaid insurance.
- The original cost of the asset is verified at the time of acquisition, but the **charge-off** takes place over several years.

- Other types of allocations directly affecting the financial statements arise because the life of a short-lived asset does not expire on the balance sheet date.
- These may include **prepaid rent and insurance.**
- Finally, accounting standards require the allocation of costs between current period manufacturing expenses and inventory as a means of reflecting **all costs of making a product.**

- Auditors commonly perform these tests as part of the audit of the related **asset or liability accounts.**
- This may include verifying depreciation expense as part of the audit of property, plant, and equipment, testing amortization of patents as part of verifying new patents or the disposal of existing ones and verifying allocations between inventory and cost of goods sold as part of the audit of inventory.

- In auditing the allocation of expenditures such as prepaid insurance and manufacturing overhead, the two most important considerations are **adherence to accounting standards and consistency with the preceding period.**
- The two most important audit procedures for auditing allocations are tests for **overall reasonableness using analytical procedures and recalculation of the client's results.**

END OF
CHAPTER 5

THANK YOU!