



**Asset Systems, Inc**

# WHITEPAPER

Fixed Asset Audit Best Practices

Most fixed asset audits are surprisingly difficult. Not only is the field confirmation tedious and error prone but the reconciliation often requires estimates and guesswork rather than definite confirmation. Not a pretty picture. However, fixed asset audits can be improved. Actions taken by the accounting department and the auditor, working together, can dramatically change how audits are conducted and the associated tedium. The following will explore why asset audits are difficult and how they can be improved.

## **Varying Requirements**

The need for fixed asset audits varies with the organization. For organizations required to file certified financial statements, the requirements are spelled out in generally accepted accounting principles. Specifically, FASB ASC 360 – Property, Plant and Equipment requires that all fixed assets be fairly valued and that any downward valuations be recorded in the current accounting period. Implicit in this requirement is the need to audit fixed assets. Audit requirements also appear in Sarbanes-Oxley, Section 404, which states that public companies must include an assessment of the effectiveness of their internal controls when they issue their annual statements. Section 404 has been broadly taken to mean that *a company cannot properly account for its fixed assets if they are not secure and properly inventoried.*

Confirmation of compliance is discussed in SAS # 1 Adherence to Generally Accepted Accounting Principles and SAS # 26 Financial Statements. According to the standard, “the auditor must confirm that the balance sheet accurately reflects the property, plant, and equipment account on the balance sheet.” Those in the private sector must also comply with the Internal Revenue Code, Section 1016, which requires that the taxpayer establish a reliable basis for all fixed assets and be able to demonstrate that their presence is confirmed.

Public organizations face an equally daunting list of requirements at the federal, state and local level. Often, the capitalization limits are set by statute rather than by normal assessments of materiality forcing the organization to capitalize and audit a large number of small value items. Equally common, audit intervals are set by statute where fixed asset audits can become annual events. Where third party

funding through grants and similar awards exist, an additional level of accounting and auditing is imposed.

With this level of formal oversight in place, no organization can afford to take shortcuts in compliance.

## **The Difficulties**

The reasons fixed asset audits present such challenge fall into two categories. The first is purely circumstantial. Often assets are spread across a number of geographically dispersed locations. Sometimes acquisitions have occurred since the last audit or capitalization limits have changed limiting the value of information available at the beginning of the audit. Because they are infrequent, audit procedures need to be revised with each audit and staff will need training. In some cases, changes in policies, practices, and personnel may affect the ease with which the audit can be completed. The other category is self-inflicted. Usually, it is the condition of the asset data that presents the real challenge. Fixed asset records often suffer from systemically weak maintenance where accounting information and field assets bear little consistency.



In some cases, entries may have been made based on groups of assets making the matching process difficult or impossible. No tagging of assets has been consistently applied or the manufacturer's serial number has not been recorded preventing a direct identification of the assets. In other cases, significant variation exists in the number and cost of the assets making meaningful sampling difficult. While correctable, these issues create far greater challenge than the circumstantial issues discussed above.

## **Traditional Audit Methods**

Regardless, the mandate to audit remains. To reduce the burden of a complete fixed asset inventory, some organizations use a statistics based approach. A statistically significant sample is identified from among all assets, these are confirmed and, if accurate, the results are extrapolated to the remainder. The statistical sample is often focused on the net book values rather than the absolute number of assets but combining the two can yield a more representative sample. However the soundness of this approach can be undone by poor quality in the underlying asset data. For example, if ledger entries include aggregate purchases, it may be impossible to determine whether such an asset should be included in the sample. Moreover, this approach may overlook older assets with little book value that often clutter the ledger but have long since been disposed and assets that should have been capitalized but have not been.

Another popular approach is using local management. A report is printed for the assets at each location. Local management is asked to review the list and confirm the presence of those listed assets. While this has the attraction of low incremental cost, it assumes that a usable report can be produced and that those charged with the task of performing the inventory have the time and knowledge to reliably verify the assets. This low cost appeal may prove elusive because comparatively high cost managers may conduct the audit rather than lower cost staff. Equally important, it is virtually impossible to confirm that the inventory has actually been performed. Conceivably, someone could simply sign the audit report without doing the actual inventory and it would be virtually impossible to detect. Despite these shortcomings, many organizations rely on this approach as the primary fixed asset audit tool believing that it produces sound results.

## **Reconciliation**

The last step in an asset inventory is to reconcile the field inventory results to the fixed asset ledger by matching the field data on a line-by-line basis to the fixed asset schedule. If the condition of the fixed asset ledgers is fair to poor, this can be an extremely time consuming process, often taking longer than the field inventory itself. Even if the descriptions and granularity of the asset record is sound, an asset recorded to the wrong location may take hours to find and a bit of guesswork to match. This is the phase where audit budgets suffer the most because the amount of effort is difficult to estimate prior to the completion of the fieldwork.

## The Current Best Practice

It is widely acknowledged that the most reliable technique to control assets is specific identification of assets based on a pre-assigned reference *that appears on the physical asset*. While most accounting systems will assign an asset identifier when a new asset is added, it is used for system administration rather than asset identification. A popular and attractive method is to record the manufacturer's serial number as a substitute asset identifier. While this data is often readily available and removes the need for the organization to label assets independently, it can have shortcomings. Some assets are not serialized. Often manufacturers will use serial numbers in ways that suit their needs varying the size, length and placement at a whim. In fact, they are often placed in locations that are difficult to record such as the battery compartment on a cell phone. Sometimes incomplete, inconsistent or inaccurate data is provided on invoices or purchasing documents. In sum, using serial numbers may be convenient but often be short of the mark.

The best solution to improved auditing starts long before the audit is required and assumes reliable application of labels on assets at the time they are placed in service. The importance of tagging assets immediately upon receipt should not be overlooked. The receiving process is a rare opportunity to properly identify, and tag the asset and record much, if not all, necessary asset data. It is imperative that this be performed in the field before the asset has had the opportunity to move and become difficult to locate.



Finally, it is axiomatic today that any asset labels support electronic identification. The present overwhelming choice for this is bar coding but the use of RFID is becoming increasingly popular. There are sound reasons for this bias. First, it enhances accuracy. By scanning a label, the user can accurately identify the asset every time. No longer is it necessary to physically identify and record the asset information – simply scan the label and the task is done correctly with near perfect accuracy. The need to have knowledge of the asset is eliminated. Second, scanning

assets is fast. With bar coding, one simply finds the label and scans it. With RFID, it is even faster. Simply activate the reader anywhere within the appropriate proximity and the scan is complete.

This electronic enhancement to the audit process means that the results are far more reliable and audit time and costs are significantly reduced. The final step is to integrate this specific identification data into the fixed asset ledger so that each asset has a unique and consistent identity. Once complete, the reconciliation of the field inventory to the fixed asset ledger is simply a matter of printing the proper report. If assets have been tagged properly, it is literally that simple.

### **Electronic Based Audit**

While the need for the audit does not change with automation, the method certainly does. In planning for the audit, the same factors are considered: partial or complete, certain categories of assets, materiality, and so forth. Once the strategy has been settled, its application is different. For example, a traditional approach might choose certain categories of assets based on net book value. An automated approach would audit all assets at a specific location because the audit is far faster than the traditional approach and can be performed by lower level employees. Once the plan is completed, the fieldwork is conducted by simply scanning the appropriate asset tags. Data is then transferred to the host, checked for quality and reports printed. The significant effort of reconciliation is virtually eliminated and savings are considerable.



### **Return on Investment**

Despite the attractiveness of an electronic audit, the ability to use this technique assumes that an asset inventory system is in place. That, in turn, requires an investment in hardware, software, and asset tagging. The returns on that investment go far beyond significantly reduced audit costs. Consider, for example:

- ! **Income tax overpayments** occurs when FA not properly recorded and depreciation deductions lost
- ! **Property tax overpayments** occurs when property taxes paid on assets that are no longer owned
- ! **Insurance overpayments** occurs when assets no longer owned are still being insured
- ! **Underinsurance risk** occurs when owned assets are NOT recorded and, therefore, not insured

! **Reduce labor** occurs when maintenance of fixed asset ledgers can be automated

! **FA theft loss** occurs with employee defalcations

Each of these elements adds weight to the argument that proper asset management provides a rapid return on investment.

### **Conclusion**

Our goal was to examine how fixed asset audits are presently being conducted and identify areas where improvements could be made. The best practice of automating the asset inventory process reduces the difficulty of audit, improves the speed and all but eliminates the need to manually reconcile the results.

Though additional technology investment is required to achieve these improvements, the justification can be based on broad saving throughout the organization. At the outset, we identified the requirement. That does not change. The only change available to you is the choice to make audits easier.

**Asset Systems, Inc.**, founded in 1987, provides asset management software, hardware, and field inventory services in a cross-section of industries and to the design firms and furniture professionals who serve them. [www.assetsystems.com](http://www.assetsystems.com)