Cover Story

Do You Know Where Your Financial Assets Are?

How to revamp PP&E records so internal controls comply with Sarbanes-Oxley.

By Alfred M. King, CMA, CFM

Suppose your external auditor is addressing a meeting of your audit committee and he or she says, "You have a material weakness in your internal controls." Are there any words more likely to cause heart palpitations in audit committee members, no less CEOs, CFOs, and controllers?

The truth is that material weaknesses in internal controls are a major problem for everyone involved in complying with Section 404 of the Sarbanes-Oxley Act (SOX). Section 404 requires the company's auditor to attest to and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board (PCAOB).

ACCOUNTING FOR PP&E

One area that's been difficult to control is property, plant, and equipment (PP&E). Every time we appraisers do a detailed study of fixed assets, we invariably determine that up to 15% or more of the assets on the books can't be found. Some were traded in on new equipment, some were scrapped, some were modified to perform a different function, and some are truly missing.

In contrast, we will often find assets on the floor that aren't on the books. When companies have strict capital expenditure policies, managers often will work around them by, for example, placing five purchase orders for $4,900 each instead of requesting one $25,000 machine. As a result, the machine will be charged to expense and not show up on the asset register. Maintenance and plant engineering personnel are skilled at building or rebuilding equipment that's needed now rather than waiting for the purchasing department to obtain quotes and go through their purchasing process. At times it's almost impossible to determine where assets came from, so the original date of acquisition and vendor information may be missing.

Furthermore, when a company acquires another, it will carry forward the fixed asset records without verifying them. So to the extent that there were errors in the target company's records, these now continue to be wrong on the new owner's books.

Another reason fixed asset accounting hasn't been accurate is that companies have made it a low priority. They've put accountants unprepared for the job in charge of it. Nor do most new accountants view fixed asset accounting as a good career path. Far better to become expert in cost accounting, budgeting, or external financial reporting, they reason.

Finally, many companies give PP&E a low priority because fixed asset accounting systems are inexpensive and can be run from a PC. The software produces all the necessary reports for financial reporting, insurance, and property taxes. Controlling PP&E appears automatic. But it's not.

Most fixed asset records are likely to be wrong and controls deficient. But Sarbanes-Oxley and the PCAOB now have made clear that perfunctory controls of their PP&E will no longer suffice.

SIZE OF THE PP&E PROBLEM

To gauge the magnitude of the problem, I analyzed data from 27 of the 30 companies in the Dow Jones Industrial Average. (I left out three financial firms—American Express, Citigroup, and J.P. Morgan Chase & Co.—because of the relatively low materiality of PP&E at these companies.)

Among the 27, gross PP&E represents 36% of total assets, and net PP&E is 19% of assets, as shown in Table 1. I think the gross figure is more important for evaluating internal controls because it represents the actual items on hand at essentially original cost. Financial depreciation isn't based directly on any diminution of true loss in value and often is overly rapid because of income tax considerations.

An even more instructive analysis is to look at depreciation expense: It is 4.6% of revenues. Although this is below the magical 5% materiality threshold that management accountants sometimes use in determining whether corrections or adjustments must be made, depreciation expense is 34% of pre-tax income. So by any standard of materiality, PP&E of 36% of assets and the related depreciation expense of 34% of income is material. This may be why the PCAOB explicitly refers to PP&E in Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" (see sidebar, "The Type of Fixed Asset Accounts Subject to Internal Control").

CONTROLLING PP&E

Historically, when auditors prepared their annual management letter, the subject of PP&E almost always came up. Often the auditors recommend that the company perform a physical inventory of its PP&E, reconcile it to what's on the books, and make necessary adjustments. But this is expensive and time consuming so often doesn't get done. But now, because of SOX, it needs to be done for effective internal control of PP&E.

In an ideal world, there would be only one solution to the problem of deficient controls over PP&E. A company would take a complete physical inventory of PP&E, just as they do of merchandise inventories. Then it would reconcile the inventory to the books, making all needed adjustments. The balance of PP&E on the books would correctly reflect the assets owned. The depreciation expense would be accurate and reliable. Information for insurance placement and proof of loss would be accurate and available. Filings for property tax assessments could be readily performed to the extent missing assets were removed from the property tax records, and insurance payments probably could be reduced.

But taking a complete inventory of PP&E and reconciling it to the books is infinitely easier to say than do. Several questions have to be answered. Should we begin with a printout of what the fixed asset ledger shows and go looking for the assets? Or do we take a new inventory of what is actually out there and try to find the assets in the ledger? Having done it both ways, I know that each approach will show large numbers of assets that can't be matched to the ledger; they're either there physically but not in the records or in the records but can't actually be found. In the absence of massive theft or fraud, the missing assets presently on the ledger and the value of assets on the floor that can't be identified in the property record may correspond roughly. But this potential offset will be of little comfort to a CFO and CEO who, under SOX, has to certify the quality of his or her internal controls, or to auditors who have to express an opinion on those assertions.

Moreover, a complete inventory and reconciliation to build better internal controls of PP&E is time consuming and expensive. Such an inventory and reconciliation could cost between $5 and $12 per line item of the property record. Whether the exercise will result in a net write-off or a net write-up is hard to determine in advance; hence it's also hard to determine whether depreciation expense will go up or down. Certainly any net write-down would be a noncash charge, with subsequent lower depreciation expense each year. The opposite, a write-up, would show a pickup to income this year, offset by higher depreciation charges in the future. Whether any such write-ups or write-downs would have to be classified as an accounting error is best left up to the company and its auditor or perhaps to the PCAOB and Securities & Exchange Commission.

But no matter the cost or time it takes for a full-scale inventory of PP&E, an audit committee may require it because of the PCAOB's emphasis on internal controls over PP&E. On the other hand, there may be a lower-cost alternative to a full-scale inventory.

A WORKABLE SOLUTION

It's possible to make the job of reconciling property records less costly and time consuming. A low-cost approach that can provide at least initial comfort to

The Type of Fixed Asset Accounts Subject to Internal Control

The Public Company Accounting Oversight Board (PCAOB) makes it clear that internal controls over property, plant, and equipment must be considered by management and reviewed by the auditor. Paragraphs 65 and 66 of the PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements," reads in part:

¶ 65. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account,
- Susceptibility of loss due to errors or fraud,
- Accounting and reporting complexities associated with the account,
- Exposure to losses represented by the account.

¶ 66. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and when inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive procedures on such balances. In an audit of internal control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

Table 1: Property, Plant, and Equipment (PP&E) Data for Companies in the Dow Jones Industrial Average (excludes American Express, Citigroup, and J.P. Morgan Chase & Co.)

Symbol	Most Recent 12 Months in Millions $ (Nov. 2003 to Nov. 2004)	Total Assets	Gross PP&E	Accumulated Depreciation	Net PP&E	Depreciation and Amortization Expense	12 Months of Revenues	Pre-Tax Income Excluding Unusual Items
MMM	**3M Company**	18,064	15,872	(10,404)	5,468	987	19,638	4,497
AA	**Alcoa**	32,308	25,132	(12,880)	12,252	1,137	23,322	2,036
MO	**Altria**	100,244	27,898	(12,066)	15,832	1,545	63,375	15,189
AIG	**AIG**	776,420	48,882	(10,703)	38,179	1,993	95,036	16,688
BA	**Boeing**	55,388	21,389	(13,056)	8,333	1,278	52,528	3,024
CAT	**Caterpillar**	40,394	1,063	(6,240)	7,303	1,088	28,145	2,562
KO	**Coca-Cola**	29,300	10,271	(4,100)	6,171	675	21,881	6,435
DD	**DuPont**	36,590	24,775	(14,394)	10,381	1,150	28,582	2,731
XOM	**ExxonMobil**	187,433	216,650	111,757	104,893	9,647	250,138	37,969
GE	**GE**	704,620	103,929	(42,482)	61,447	7,990	145,187	20,386
GM	**GM**	468,635	105,955	(35,040)	70,915	13,938	190,764	4,215
HPQ	**Hewlett-Packard**	74,381	13,507	(7,262)	6,245	1,813	78,369	4,411
HD	**Home Depot**	38,331	26,113	(5,152)	20,961	636	71,407	7,769
HON	**Honeywell**	29,988	11,286	(7,100)	4,186	586	25,148	1,769
INTC	**Intel**	47,800	40,138	(24,214)	15,924	4,623	33,352	10,640
IBM	**IBM**	100,676	37,156	(22,548)	14,608	3,973	94,745	11,812
JNJ	**Johnson & Johnson**	52,089	17,632	(8,037)	9,595	1,177	45,850	12,375
MCD	**McDonald's**	26,338	29,072	(9,421)	19,651	1,163	18,610	3,261
MRK	**Merck**	42,874	22,255	(7,821)	14,433	1,187	22,818	8,568
MSFT	**Microsoft**	94,268	6,197	(3,880)	2,317	502	37,809	13,298
PFE	**Pfizer**	122,229	25,489	(8,012)	17,477	1,887	52,027	14,965
PG	**Procter & Gamble**	59,203	25,343	(11,359)	13,984	1,641	52,956	9,679
SBC	**SBC Communications**	101,986	135,454	(85,398)	50,056	7,442	40,821	6,280
UTX	**United Technology**	37,631	12,149	(7,276)	4,873	914	36,195	4,573
VZ	**Verizon**	162,897	183,356	(109,870)	73,486	13,435	70,502	12,274
WMT	**Wal-Mart**	118,089	84,886	(20,343)	64,543	3,848	277,499	15,649
DIS	**Walt Disney**	54,561	27,647	(11,399)	16,248	1,119	30,223	3,768
	Total Nonfinancial	**3,612,738**	**1,299,496**	**(398,702)**	**689,761**	**87,375**	**1,906,927**	**256,823**

Gross PP&E as a Percent of Total Assets	36.0%
Net PP&E as a Percent of Total Assets	19.1%
Depreciation Expense as a Percent of Revenue	4.6%
Depreciation Expense as a Percent of Pre-Tax Income	34.0%

Source: Securities & Exchange Commission

CFOs, CEOs, and audit committee members involves performing a complete reconciliation, but initially only on a statistically significant portion of the asset records.

Here's how it can be done: Most asset ledgers have a location for each line item, so each one can be sorted by location and in descending dollar amounts. Then the largest 80% of the items in dollar terms—probably 20% of the items overall—should be physically located, recorded, and checked against the overall property record system. As noted above, some of the items on the ledger won't be found, and some of the items found won't be on the ledger. These form two additional groups of records from which numerous small items can be taken off the list. Those remaining will offset each other approximately in dollar terms. The items not on the ledger are appraised, given fair market values, and added to the ledger. Now depreciation expense from here forward will be correct.

This process can be carried out sequentially over a period of months until the company's largest PP&E items have been reconciled, the missing items written off, and items physically there now carried on the books. Compared to a total company approach, this method costs less, and the net dollar difference is probably minimal and won't make the company's financial statements materially in error. But above all, the new and accurate property records are a basis for implementing a sound control system.

But there's still one major task to accomplish: placing rigorous controls on managers and supervisors and holding them personally responsible for the accuracy of the fixed asset records compared to the actual PP&E. In subsequent inventories, any errors will be charged to their department's operations, and that department's performance will be affected correspondingly. By making managers personally responsible, assets are unlikely to go missing or suddenly appear inexplicably. Nor is it likely that assets will be transferred, sold, or traded without the necessary accounting entries. Other entries, such as those for maintenance or capital expenditure, will be applied properly.

Furthermore, I strongly recommend that companies significantly increase the minimum capitalization amount because what isn't capitalized is charged to expense, so not recording an expenditure as an asset means it won't appear in the fixed asset register. Many of the errors and difficulties in controlling PP&E can be traced to overwhelming but insignificant detail. For most companies, adopting a minimum of $10,000, or even $25,000 for major multinational firms, would reduce the number of entries, but control can still be maintained because the recorded assets are the ones with significant value. Recording items at a low capitalization level of $500, $1,000, or even $2,000 only results in extra work and *less* control. When small items are purchased, they should be charged to expense.

An argument will be made that overall expense will go up in the year the inventory and reconciliation occur because the formerly capitalized low-dollar items continue to be depreciated while new acquisitions will also be charged to expense. But the overall rationale for the change holds: The old control system doesn't work well and won't satisfy the SOX internal control requirements. The cost in the year of the changeover can't be avoided and, if it's material, should simply be considered part of SOX.

Having a fixed asset control policy that works well is going to require company resources. But that may be justified now that audit committee members, CEOs, CFOs, controllers, and financial managers must be personally involved. ■

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