GHOST AND ZOMBIE ASSETS

It's Midnight.

Do You Know Where Your Assets Are?

By Alfred M. King, CMA, CFM

Internal Control may well be the watchword of the financial community this decade. Enron, HealthSouth, and WorldCom focused investors' attention on the accuracy of financial statements, particularly fixed assets, which are sometimes referred to as Property, Plant, and Equipment (PP&E). The massive losses faced by investors in those firms caused Congress to pass the Sarbanes-Oxley Act of 2002 (SOX), which in turn led to the creation of the Public Company Accounting Oversight Board (PCAOB). Now that the PCAOB is seen to have teeth, the major auditing firms have focused ever-increasing attention on internal controls. In fact, there have been numerous complaints that auditors are spending too much time reviewing their clients' internal control systems. Further, companies are now required to report on the quality and effectiveness of their own internal controls. Then auditors, after spending massive resources, provide shareholders and the SEC with an opinion on their clients' internal controls.

In my firm's work with a number of publicly traded companies complying with SOX, we occasionally review the property records. Often this work is being done in performing an allocation of purchase price for a business combination in accord with Statements of Financial Accounting Standards (SFAS) Nos. 141 and 141R, "Business Combinations." In order to minimize the time and cost of the valuation work called for by Generally Accepted Accounting Principles (GAAP), at times we will want to be able to use the fixed asset records of the target company.

We do two things. First, we test to make sure that the major pieces of equipment are there. Second, we evaluate their condition. To determine the fair value of PP&E, we generally look at the cost of a comparable new piece of equipment and, applying professional judgment, adjust the value to reflect the observed depreciation on the subject asset. Keep in mind that valuation specialists don't use book or tax depreciation. Rather, the fair value is based on *physical observation* of the client's newly acquired asset combined with professional valuation experience. Fair value (required by GAAP) may differ from the book value on the acquired company's accounting records, but it's often within 10% to 20%. As a generalization, book and tax depreciation is too rapid, offset by functional obsolescence from new equipment.

Most companies use the lives authorized for tax depreciation for the book depreciation, thus avoiding deferred tax entries. But the lives allowed for tax purposes have been shortened over the years in order to encourage companies to invest in PP&E. Tax lives now generally are much shorter than the actual useful lives of the assets at the company owning and using them. Sometimes, of course, rapid technological changes occur that aren't reflected in the approved tax lives, and companies then may want to accelerate the depreciation charge for financial reporting. These two phenomena—too long tax lives and too short recognition for obsolescence—at times can offset each other.

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As professionals with years of experience, we can readily determine the fair value of assets that we can locate and inspect. The key word here is "locate."

All too often, unfortunately, neither we nor the client can actually find assets that are on the property ledger. We refer to these as **Ghost Assets**. Our definition of ghost assets is usually accepted as soon as people understand the problem. The assets are on the books, supposedly under the control of the company. But they appear to have "vanished," leaving only a trace on the ledger, with no material essence. In many cases, ghost assets can be as high as 15% of a firm's total PP&E when a detailed inventory is taken. Maybe it's time to call Ghostbusters!

Offsetting these missing or "ghost" assets are what we refer to as **Zombie Assets**. Our definition of a zombie asset is simple. It's an asset that you have physically but have nothing in the accounting records to support this. In other words, a zombie asset is physically present but not alive on the company's books. (One online dictionary definition of a zombie is "any incorporeal supernatural being that can become visible to human beings.")

If "ghost assets" is the proper term for assets on the books that can't be found, we recommend the term "zombie assets" for those not on the books but present and in use.

Physical Inventory of PP&E

The current problem is that few companies perform a periodic reconciliation of the property ledger to assets actually on the floor. Therefore, a company really has no way of identifying the accuracy of the fixed asset ledger, so auditors really can't certify that the internal controls over PP&E are functioning.

It appears that, almost by definition, the existence of ghost assets and zombie assets defines a material weakness in internal control. But since everything is relative, one missing PC isn't the same as a one-line entry for several million dollars labeled "Addition," which was totally unidentified in the accounting records. (This latter was a real entry on the books of a real company.)

The number of reasons that assets can go missing and turn into ghosts is almost infinite. A partial list includes:

- Unrecorded trade-ins;
- Cannibalization of existing machines in order to repair other units;
- Factory rearrangement, with "unneeded" items scrapped;
- New conveyor system replaces old system, but old system never written off; and
- Addition to factory involves tearing down the old common wall, with no accounting entry made for partial loss of the old structure.

But there may be offsetting good news in terms of calculating a net loss. In other words, if you take a physical inventory of a production area, you may also find the zombie assets physically present that can't be easily identified against anything on the fixed asset ledger. Again there are many reasons this can happen, including:

- Self-constructed assets;
- Buying a larger machine in small increments to avoid capital expenditure requests;
- Fully depreciated assets written off but still in use;
- Trade-in credit by supplier, but item retained because seller has no need for it; and
- Physical transfer from a remote company location but with no accompanying paperwork.

Why Internal Controls of PP&E Are Deficient

As a broad generalization, internal controls over PP&E are sadly lacking in many companies. This doesn't necessarily apply to *your* company, but it's applicable to almost everyone else. The consensus of many analysts is that gross PP&E can easily be one third (33.3%) of total company assets. By any definition of materiality, internal controls over PP&E can't be dismissed solely on the grounds that they aren't material.

If PP&E balances *are* material to a company, and hence should be subject to good internal controls, why this current lack of effort? Companies and auditors spend significant time on receivables and inventories, much more than they do on PP&E. By and large, it's our observation that internal controls on receivables are usually very good. After all, if they aren't, short-term cash flows will be affected. Similarly, internal controls on inventories are almost uniformly handled properly because good inventory records are necessary in order to meet production and sales commitments. We don't even have to discuss internal controls on cash, financial instruments, or rev-

A ZOMBIE ASSET IS PHYSICALLY PRESENT BUT NOT ALIVE ON THE COMPANY'S BOOKS.

enue recognition inasmuch as these seem to be the current area of concern for the PCAOB and, hence, management, auditors, and the SEC—not to mention investors and creditors.

Somehow, PP&E is the "poor stepchild" of internal controls. After many years of working with clients on valuation issues involving tangible assets, we've drawn the following conclusions.

◆ Until the last few years, most management attention, as well as that of auditors and analysts, was placed on the profit-and-loss (P&L) statement, which was looked at in terms of "Have we got the right income?" In turn, this called for putting in maximum effort to make sure that revenue and expense were properly "matched." This concept of matching, which many of us grew up with, placed full emphasis on income and expense and tended to look at the balance sheet as a residual that held such unidentifiable items as "deferred tax liabilities" and "goodwill as an asset."

◆ As long as the emphasis on internal controls was on the income statement and not the balance sheet, then resources (both internal and external) were focused on income and expense items. Depreciation expense was considered a "noncash charge." New capital expenditures had to pass the organization's capital budgeting requirements, but these affected the P&L only in terms of a small addition to depreciation for the current year.

◆ The emphasis on the P&L meant that corporate controllers and independent auditors would look to see that this year's depreciation expense was in line with last year's, taking into account retirements, betterments, and new acquisitions. In practice, there was far more attention paid to relative depreciation expense (this year compared to last year) than to the absolute dollar amount.

◆ In this environment, what's the impact of poor internal controls over PP&E? The answer, focusing on the income statement, is "not much." If an asset is still on the property ledger but, say, was traded in and is no longer owned by the organization, there's virtually no current P&L impact! In the current and future years, the remaining undepreciated cost will ultimately be written down to zero, thus balancing the books at that point in time with the underlying reality.

In short, *many companies felt that any errors in fixed asset accounting were going to be self-correcting*; consequently, limited accounting resources ought to be placed in areas of greater importance. This mind-set led to a further problem. As a generalization—based on more than 50 years of business experience—most companies don't put their highest-potential accountants in charge of fixed asset accounting. High-potential accountants want to work in budgeting, finance, capital expenditures, and M&A. Fixed assets, as an area of expertise, is often considered a "backwater" with little or no room for professional growth. How many corporate CFOs obtained their current position because of exceptional performance in controlling PP&E?

In many cases, the responsibility for fixed asset accounting is delegated to a brand new accountant with an expectation that he or she "has to learn the business and might as well start in property records." But in some companies, fixed asset accounting is given to the most senior member of staff, one waiting patiently for retirement. After all, fixed asset accounting has little excitement, few deadlines, and often very little management oversight.

So now you understand just how companies find themselves with fixed asset records that bear little relationship to what's out on the shop floor. Little management attention, combined with what's perceived as an unglamorous assignment and accentuated by modest independent auditor scrutiny, simply doesn't get the job done.

It's true that many "management letters," prepared by independent auditors at the end of the engagement, recommend that a company take an inventory of fixed assets and reconcile it to the books. Companies dutifully respond that, "Yes, this is on our to-do list" and then put the issue off for another year.

Why the procrastination or lack of effort to take a physical inventory of PP&E? Because the effort is far from trivial. It's a great deal of work to reconcile what's out there with what the books show. Further, and perhaps even more important, there can be a potential hit to the P&L if the ghost assets are written off. Even worse, it's difficult to write back up any zombie assets that are located.

It's also true that companies can achieve real cost savings by eliminating assets from the property ledger. These are primarily in the areas of property taxes and insurance. Both property tax liabilities and insurance expense are based on a firm's fixed asset ledger, so a correction of the ledger balances should, and probably will, result in savings.

The problem is that GAAP requires the write-down of unreconciled ghost assets, and there's little possibility of offsetting this with a write-up of the inevitable zombie assets. Few controllers and CFOs want to take that kind of charge, even though it can be labeled both "nonrecurring" and "noncash." Taking a write-down today because of bad accounting records or previous poor internal control reflects adversely on *current*, not past, financial management. Postponing any day of reckoning into the future almost always looks like a good short-term strategy. "Let someone else worry about this" is the usual mantra.

SOX Implications for Ghost Assets

With the current attention on the accuracy of the balance sheet and a possible move to further disclosures about the fair value of assets, it appears that over the next few years companies will have to get serious about internal controls over fixed assets. Once auditors are satisfied that their clients' controls over *other* areas are good, emphasis will switch to PP&E. PCAOB auditors, reviewing the working papers of independent accountants, are going to start looking at how management and, by extension, auditors are really implementing a sound internal control system.

The usual approach to implementing a sound system of internal control over PP&E is twofold. First, a company has to get serious about internal control and make sure that existing procedures are being followed. This includes mandatory paperwork from the shop floor about transfers, trade-ins, and rebuilding/reworking existing assets. Capital expenditure approval must tie in to Construction in Process (CIP) and, finally, full capitalization. Required entries to the property ledger should be readily identifiable, usually with company-administered serial numbers applied to each asset. With current radio frequency identification (RFID) technology it's easy to take an inventory if all the assets have been properly tagged and reconciled. While the initial cost for RFID tags is relatively high, the savings in reconciling physical inventories to the books is substantial.

Minimum capitalization policies should be implemented and enforced. Most companies have minimums that are ridiculously low. A $100 million company shouldn't try to control assets that have an original cost of $500, which we often see as the capitalization cutoff. Medium-sized companies should probably establish a limit of $5,000, with everything under that charged to expense. Cries of alarm will go up that "We won't have control over personal computers!" True. But what kind of control do you have today? Further, if physical control is necessary, you can set up a memo file about PCs without capitalization. Put another way, physical control and minimum capitalization levels are totally independent.

Another argument against minimum capitalization levels comes from accountants who are sensitive to tax issues. It's possible that raising a capitalization policy from $500 to $5,000 may increase expense in the year of adoption. Over a three-to-five-year period, however, the net effect will be negligible. Since tax audits often occur two to four years late, by the time your Internal Revenue Service agent is reviewing your return, a switch back to a minimum capitalization for taxes would increase taxable income the first year and reduce it in subsequent years. As long as you are consistent regarding books and taxes and can demonstrate that it's more efficient to capitalize only larger assets, reason should prevail (I would hope). One argument can be that studies have shown that companies spend some $5 per year per line record on the fixed asset ledger. Combined with the savings in property taxes and insurance, even a hardened revenue agent should be reasonable because of the income offset.

In short, step one is to develop, and implement from here forward, a sound system of internal controls. That's the easy part.

Now for step two. The hard part is getting today's property ledger to reflect accurately what the company really has. Ghost assets have to be written off. Zombie assets have to be traced back to original entries, and the descriptions have to be redone to reflect the current state of the asset(s).

Taking a physical inventory of assets is a major effort, which is why companies keep postponing it. You have to decide whether to identify the assets on the floor and try to reconcile them back to the books or to take the asset ledger printout and try to find all the items. It's beyond the scope of this article to resolve this issue. Suffice it to say that, in some cases, one alternative is preferable, and, in others, the reverse should be used.

At the end of the day, the basic principle is to write off ghost assets and assign unidentifiable costs on the ledger to the zombie assets. Ideally, this effort—and it's a major effort—should be undertaken with a team of company employees guided by consultants with inventory and valuation experience.

Once this job is complete, the books equal the real assets, and a sound system is in place to *maintain* the records, any corporate controller or CFO can look the audit committee in the eye and affirm that internal controls over PP&E are in place and functioning properly.

One last note: If you have one takeaway from this article—one thing to keep in mind—it should be: **"Busting ghosts and bringing zombies to life—that's the mission."** **SF**

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