**Chapter-5**

**Audit of Property, Plant, and Equipment**

Fixed assets are sometimes referred to as Property, Plant and Equipment (PP&E) and the terms are used interchangeably. The term property, plant and equipment include all tangible assets with a service life of more than one year that are used in the operation of the business and are not acquired for the purpose of resale. Three major subgroups of such assets are generally recognized:

1. Land, it has the significant characteristic of not being subject to depreciation.
2. Buildings, machinery, equipment, and land improvements, such as fences and parking lot, have limited service lives and are subject to depreciation.
3. Natural resources (wasting assets) such as oil wells, coal mines, and tracts of timber, are subject to depletion as the natural resources are extracted or removed.

Internal control over property, plant, and equipment is designed to safeguard the assets and provide accurate accounting records for management control, depreciation and salvage value calculations, and to make correct entries for retirements and disposals. The following guidelines will be helpful in establishing this control:

* There is an effective system of authorization and approval with respect to capital expenditures.
* Capitalization and depreciation policies are defined in writing.
* There are detailed records of individual asset items which are balanced periodically with general ledger control accounts.
* There are effective procedures regarding the authorization and accounting for disposals.
* Donated property and equipment is reported at its fair market value on the date of donation.

The administrator may wish to attach an identifying tag to each piece of departmental equipment to track the equipment locations.

**Internal Controls**

An auditor should review the system of internal controls relating to PPE, particularly the following:

(a) *Control over expenditure incurred on PPE acquired or self constructed*- An effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorization of the expenditure incurred, also shows, in general, how effectively such expenditure is being controlled through periodical comparisons of actual with budgeted figures. It also ensures that amounts expended do not exceed the amounts authorized, and controls allocation of expenditure between capital and revenue in the case of self constructed assets.

(b) *Accountability and utilization controls*-Accountability over each PPE is established, among other things, by maintaining appropriate records. This facilitates control over custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of PPE. On the other hand, utilization controls ensure that the individual PPE have been properly used for meeting the objectives of the entity.

(c) *Information controls*-These controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims, controlling repairs and maintenance charges or expenses incurred for inspection to assess the condition of the asset, replacement cost of specific parts, useful life of assets or specific parts, eg, specified number of hours of use, etc.

(d) *Safeguarding of assets*-These controls ensure that the assets owned by the entity are safeguarded and any loss on damage/destruction of such assets are made good, through for example, insurance of assets, warranties, etc. The entity may have a process by which responsibility to safeguard the assets could be identified to specific personnel.

**Internal Control Checklist**

The following checklist has been developed to allow administrators to review their existing system of internal control in a systematic manner to determine areas where improvement of procedures may strengthen controls. In considering changes in accounting controls, the administrator must evaluate the cost-benefit relationship of varying levels of control procedures and select the procedures which are appropriate in the circumstances. Also, it should be recognized that no checklist can contain all procedures that may be appropriate in all circumstances and, accordingly, the administrator should not limit his or her consideration to those items contained in the checklist. The following checklist discusses accounting controls.

**Accounting Controls of Property, Plant, and Equipment**

1. Are administrative authorizations and approvals required to originate an expenditure which will be chargeable to fixed assets and in this respect are policies adequate regarding minimum amounts capitalized, minimum amounts requiring approval at various levels, distinction between repairs, replacements, renewals, betterments, treatment of freight and other collateral costs, etc.?
2. Are work orders established to assist in the proper accounting for items to be capitalized?
3. Are supplemental authorizations required for excess expenditures?
4. Are there detailed plant records showing the asset values for the individual items of plant and equipment and dates placed in service?
5. Are the detailed records integrated with the financial accounting system?
6. Is the accuracy of these records independently checked by periodic, physical inspection?
7. Are records kept of equipment on hand but not carried in the general books, such as fully depreciated equipment still in use, obsolete equipment and idle equipment?
8. Is written authority required for fixed asset dispositions?
9. Does the accounting department receive copies of such authorizations?
10. Is the estimated salvage value shown on all retirement orders and followed up for subsequent cash receipts?
11. Are periodic reports submitted showing obsolete equipment, equipment needing repairs, or equipment not in service for any other reason?
12. Are procedures in effect to prevent depreciation of fully depreciated assets?
13. Is gain or loss computed on all fixed asset dispositions?

**Auditors’ approach in examination of property plant, and equipment:**

The auditor’s objectives are to determine that:

1. Internal control over property, plant, and equipment is adequate
2. The recorded property, plant, and equipments is valid (existence and rights)
3. All property, plant and equipment is recorded(completeness)
4. The valuation of property, plant and equipment is proper
5. The presentation and disclosure of plant, and equipment including disclosure of depreciation methods, is adequate.

**Audit procedure for property, plant and equipment:**

**A) Consider internal control for property, plant and equipment:**

1. Obtain an understanding of the internal control
2. Assess control risk and design addition test of controls
3. perform additional test of controls
4. Reassess control risk and design substantive test

**B) Substantive test:**

1. Obtain a summary analysis of changes in property owned and reconcile to ledgers
2. Vouch additions to property during the year
3. Make a physical inspection of major acquisitions of plant and equipment
4. Analysis repair and maintenance expense account
5. Investigate the status of property not in current use
6. Test the client’s provision for depreciation
7. verify retirements of property during the year
8. Verify legal ownership of property, plant and equipment
9. Review rental revenue from land, buildings, and equipment owned by the client but leased to others
10. Examine lease agreements on property, plant and equipment leased to and from others
11. Perform analytical procedures for property, plant and equipment
12. Evaluate financial statements presentation and disclosure for plant assets and for related revenue and expenses.

**To summarize:**

In this chapter we presented the appropriate controls for property, plant, and equipment accounts, the auditors' consideration of these controls, and the substantive procedures for property, plant, and equipment.

* The financial statement capital "property, plant, and equipment" includes tangible assets with a useful life of more than one year that are used in operations. In the audit of property, plant, and equipment, the auditors' primary objectives are to (*a*) consider inherent risks, including fraud risks; (*b*) consider controls over these assets; (*c*) determine the existence of property, plant, and equipment; (*d*) establish the propriety of the valuation or allocation methods, including the reasonableness of the depreciation program; (*e*) establish the completeness of recorded property, plant, and equipment; and ( *f* ) evaluate the adequacy of presentation and disclosure for property, plant, and equipment.
* Key controls over property, plant, and equipment should include proper authorization of acquisitions, adequate records for the various units of property, periodic physical inspection of property, and the use of serially numbered retirement work orders.
* In the audit of property, plant, and equipment for a continuing client, the emphasis of the testing is on transactions that occurred during the year, as contrasted to an emphasis on ending balances. Depreciation expense is often tested by re computation or through the use of analytical procedures.
* The auditors' objectives for the audit of natural resources and intangible assets are similar to those for property, plant, and equipment. Often in auditing the depletion of natural resources, the auditors must rely upon specialists to estimate the quantity and quality of the resource. The audit of intangible assets typically involves vouching the cost of the assets and evaluating and testing the allocation methods used by the client.
* A significant risk with respect to property, plant, and equipment and intangible assets is the risk of unrecognized impairment.

Procedures:

* Describe the nature of property, plant, and equipment and depreciation.
* Identify the auditors' objectives for the audit of property, plant, and equipment.
* Explain the fundamental controls over property, plant, and equipment.
* Assess the risks of material misstatement (inherent and control risks) of property, plant, and equipment.
* Design typical tests of controls used by auditors to support the assessed risks of material misstatement (inherent and control risks) for the financial statement assertions related to property, plant, and equipment.
* Explain how the auditors design substantive audit procedures to address the risks of material misstatement of property, plant, and equipment.
* Explain the auditors' approach to the audit of depreciation.
* Describe how the auditors design audit procedures to audit intangible assets.