

CHAPTER 8

The Why and How of Auditing Property

Plant, property, and equipment is often the largest item on a balance sheet. But the risk is usually low to moderate. After all, it's difficult to steal land or a building. And the accounting is usually not difficult. So the dollar amount can be high but the risk low.

In this chapter, we'll answer questions such as, "How should we test additions of property?" and "What should we do in regard to fair value impairments?"

Auditing Property — An Overview

I will refer to plant, property, and equipment as *property*.

Property is purchased for use in a business. For example, a corporate office might be bought or constructed. The building is an asset that is depreciated over its economic life. As depreciation is recorded, the book value (cost less accumulated depreciation) decreases. In other words, you expense the building as it is used.

In most reporting frameworks, assets are recorded at cost. Appreciation in the value of property is not recorded, but a significant decrease, known as an impairment, is recognized. Property improvements (e.g., adding a new room to an existing building) are capitalized and depreciated. Repairs like painting a room are not. They are expensed as incurred.

Also, most businesses elect to use a capitalization threshold such as \$5,000. For these entities, amounts paid below the threshold

are not capitalized, even if they extend the life of the asset. Such amounts are expensed as incurred.

How do most entities track property purchases and compute the related depreciation? They use depreciation software. When property is purchased, it is added to the depreciation software and an economic life (e.g., ten years) is assigned. Thereafter, the cost and depreciation are maintained in the software. Journal entries are made in the general ledger to record the depreciation for each period.

Below we will cover the following:

- Primary property assertions
- Property walkthroughs
- Directional risk for property
- Primary risks for property
- Common property control deficiencies
- Risk of material misstatement for property
- Substantive procedures for property
- Common property work papers

Primary Property Assertions

First, let's look at assertions.

The primary relevant property assertions include:

- Existence and occurrence
- Completeness
- Valuation
- Classification

Of these assertions, I believe existence, occurrence, and classification are generally most important. The client is asserting that property exists, that depreciation expense is appropriate, and that amounts paid for property are capitalized (and not expensed). If the value of a property is significantly impaired, then the valuation assertion is relevant.

Property Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions.

In performing the walkthrough, ask questions such as:

- Are property ledgers reconciled to the general ledger?
- Does the entity use reasonable and consistent depreciation methods?
- Are the depreciation methods in accordance with the reporting framework?
- Who records depreciation?
- Are the economic lives assigned to property appropriate?
- What controls ensure that property is recorded in the right period?
- Is there appropriate segregation of duties between persons who purchase, record, reconcile, and physically possess property?
- What software is used to compute depreciation?
- Does the company perform periodic physical inventories of property?
- Are assets removed from the depreciation schedule and the general ledger upon sale?
- What controls ensure that property purchases are added to the depreciation schedule (and not expensed as repairs and maintenance)?
- What controls ensure that repair expenses are not capitalized as property?
- What is the capitalization threshold (e.g., \$5,000)?
- Is there a written policy for bidding purchases?
- How are bids reviewed and documented?
- Is there a written policy for disposal of assets?

As we ask questions, we also inspect documents (e.g., depreciation reports) and make observations (e.g., who has access to moveable property?).

If control weaknesses exist, we create audit procedures to respond to them. For example, if—during the walkthrough—we see that one person purchases property, has physical access to equipment, and performs the related accounting, then we will perform theft-related substantive procedures.

Directional Risk for Property

Third, consider the directional risk of property. The directional risk for property is that it is overstated. So, in performing your audit procedures, perform procedures to ensure that property is not overstated. For example, vouch all significant property additions to invoices. See if the amounts added to property are equal to or greater than the capitalization threshold (e.g., \$5,000).

Primary Risks for Property

Fourth, think about the risks related to property. The primary risks for property include:

- Property is intentionally overstated
- Repair expenses (or any other expenses) are improperly capitalized
- Purchases that should be recorded as property are expensed
- Depreciation is improperly computed and recorded (e.g., accelerated depreciation is used when straight-line is more appropriate)
- Moveable property like equipment is stolen
- Those with purchasing power receive kickbacks from outside parties (e.g., vendors)

Common Property Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment work.

In smaller entities, it is common to have the following control deficiencies:

- One person performs more than one of the following:
 - Authorizes the purchase of property
 - Records the property in the general ledger and depreciation schedule
 - Has physical custody of the property
 - Has responsibility for reconciling the depreciation schedule to the general ledger
- The person maintaining depreciation records lacks the knowledge to do so
- A second person does not review the depreciation methods for appropriateness and economic lives assigned to each property
- No one performs surprise audits of property
- No one performs physical inventories of property
- There are no controls over the disposal of property
- Appropriate bidding procedures are not used
- No one reconciles the depreciation schedule to the general ledger
- Property is not reviewed for potential impairments of value

Risk of Material Misstatement for Property

Sixth, assess your risks of material misstatement with the information you've gathered.

The assertions that concern me the most are existence for additions to property, occurrence for depreciation, and classification of property. With regard to classification, the business determines whether the amount should be capitalized or expensed. My RMM for these assertions is usually moderate to high.

My response to higher risk assessments is to perform certain substantive procedures: namely, vouching additions to property. (Vouching means to compare property additions to invoices paid.) As RMM increases, I use a lower dollar threshold for vouching.

If controls related to bids are weak, your RMM for existence can be high. Bid rigging or kickbacks (fraudulent vendor actions) can result in overstatements of property.

Substantive Procedures for Property

Finally, it's time to determine your substantive procedures in light of your identified risks.

My customary audit tests are as follows:

- Vouch property additions to related invoices
- Agree opening property balances in the depreciation schedule to the prior year ending balances
- Review economic lives assigned to new property for appropriateness
- Review the selected depreciation method in light of the property's economic life—does the property lose value quickly or evenly over time?
- Compute a ratio of depreciation to property and compare the result with prior periods
- Inquire about potential decreases in the value of property and request valuations if necessary
- Review significant bid documentation

I don't normally test controls related to property. If controls are tested and you determine they are effective, then some of the substantive procedures may not be necessary.

Common Property Work Papers

My property work papers normally include the following:

- An understanding of property-related internal controls
- Risk assessment of property at the assertion level
- Documentation of control deficiencies related to property
- Property audit program

- A copy of the depreciation schedule that agrees to the general ledger
- A summary of additions and retirements of property in the current audit period
- Bid documents for significant construction projects or other property purchases
- A valuation of a significant asset by a valuation specialist, if needed
- Disclosure checklist

Auditing Property - A Simple Summary

- Primary relevant property assertions include existence for property, occurrence for depreciation, and classification with regard to whether the amount should be capitalized or expensed.
- Perform a walkthrough of the property cycle by making inquiries, inspecting documents, and making observations
- The directional risk for property is that it is overstated
- Primary risks for property include:
 - Property is intentionally overstated
 - Repair expenses are improperly capitalized
 - Purchases that should be recorded as property are expensed
 - Depreciation is improperly computed and recorded
 - Moveable property is stolen
 - Those with purchasing power receive kickbacks from outside parties (e.g., vendors)
- The substantive procedures for property should be responsive to the identified risks. Common procedures include:
 - Vouching property additions to related invoices
 - Agreeing opening property balances in the depreciation schedule to the prior year ending balances
 - Reviewing economic lives assigned to new property for appropriateness

- Reviewing the selected depreciation method in light of the property's economic life
- Computing a ratio of depreciation to property and comparing the result with prior periods
- Inquiring about potential decreases in the value of property and requesting valuations if necessary
- Review significant bid documentation

Now you know how to audit property.

Next we'll turn our attention to the audit of accounts payable and expenses.