Inventorying CAPITAL ASSETS

BY KEVIN HARPER

A well-planned physical observation of capital assets will avoid "sticky wickets" in the future

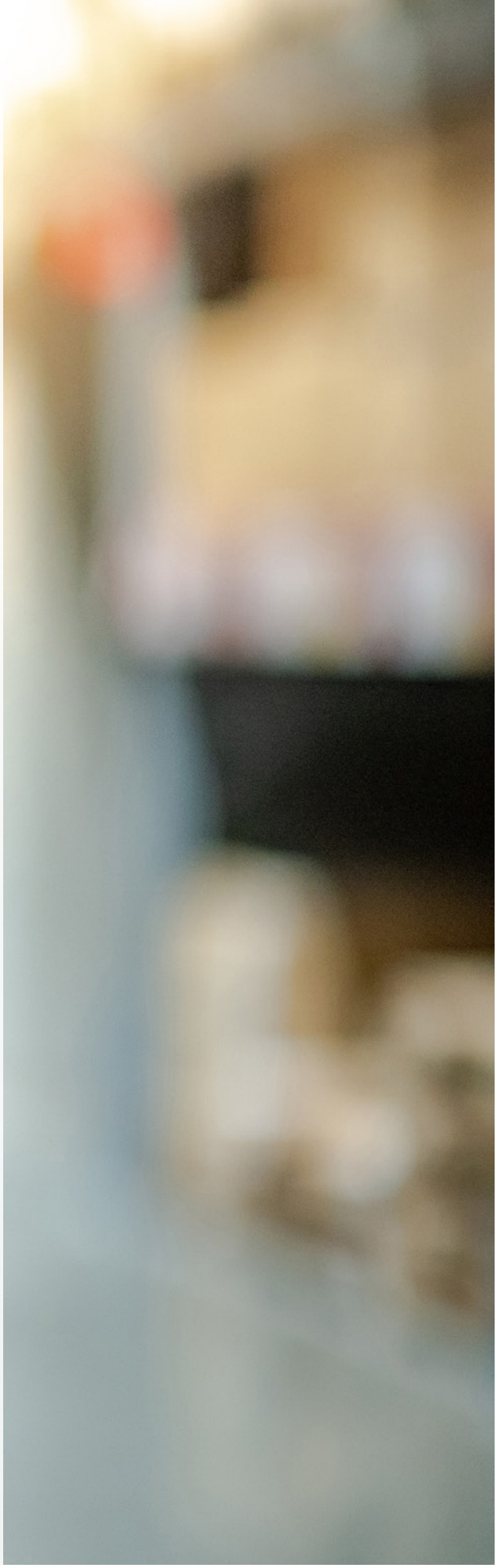
Capital assets are defined as all tangible and intangible assets used in operations that have useful lives greater than one year. They get no respect, even though they are usually the largest asset on a government's statement of net position. But government accountants and auditors have not historically given a proportionate level of attention to the accounting and internal controls related to capital assets. This is mostly due to two reasons.

First, infrastructure is by far the largest category of government capital assets. Infrastructure has frequently not been viewed as an asset by governments because it is not usually able to be sold. In fact, infrastructure has sometimes been viewed as a liability because of the requirement for governments to use future resources to maintain. I have been involved in negotiations between governments that have shared construction costs in the building of a new asset. Each argued against taking the asset onto their books, so they didn't have to take responsibility for maintenance and ultimate replacement.

Second, prior to *Governmental Accounting Standards Board Statement No. 34,* governmental capital assets were recorded in a "general fixed assets account group," but not in any consolidated or fund financial statement. Infrastructure assets weren't recorded at all. Auditors did not place much attention on capital assets during annual audits because they determined that even huge variations in the amount of assets recorded in this account group would not greatly impact users' judgment about the financial position of the government.

Because accountants and auditors did not put substantial effort into tracking capital assets, physical inventories of capital assets were seldom done. However, in recent years, now that capital assets are recorded in the entity-wide financial statements, government accountants and auditors have been giving capital assets more attention. For example, auditors are delivering audit findings such as:

- There is no formal effort to cleanse the database of out-of-service assets.
- Written policies and procedures for capital assets are inadequate.
- There is no comprehensive plan to perform a physical inventory of capital assets.



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Preparing to Inventory Capital Assets

The Government Finance Officers Association (GFOA) recommends that governments inventory their tangible capital assets, at least on a test basis, no less than every five years. A practical interpretation of this recommendation is to observe moveable equipment every five years and other assets (land, buildings, infrastructure, non-moveable equipment) once every 10 to 20 years. It is better to observe a portion of your capital assets each year on a rotational basis than to do them all at once every few years because it allows you to (a) test the adequacy of your internal controls each year and (b) build observation work into annual workloads so that you don't need to engage consultants.

Following is a typical process for conducting physical observation of capital assets. I'll discuss each step of this process in more detail.

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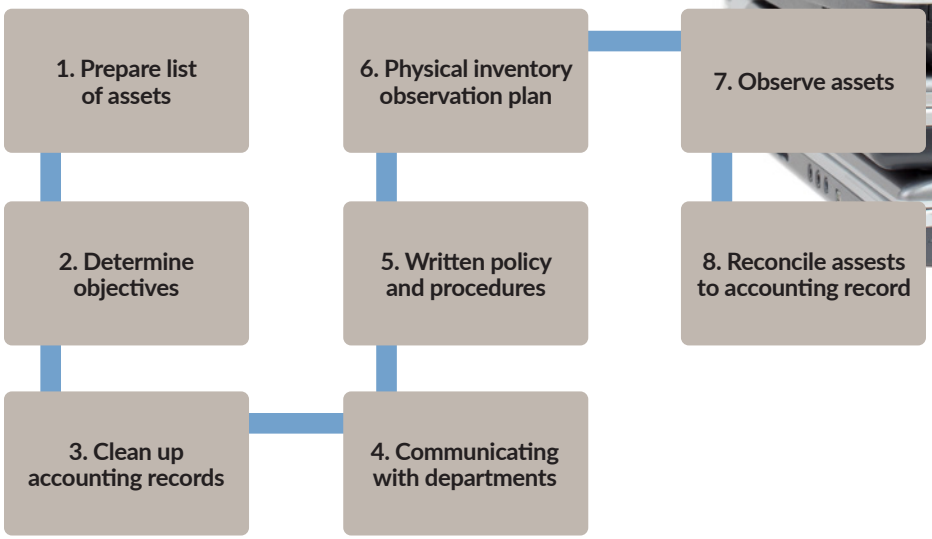

1. Prepare a List of Assets

First, prepare a list of capital assets by type of asset. Following is an example of such a list:

	Number of Assets	Gross Book Value (thousands)
Land	60	$3,000
Land improvements	94	56,000
Buildings and improvements	915	2,696,000
Infrastructure	760	810,000
Equipment and furniture	3,381	131,000
Works of art	38	9,000
Intangible assets	113	18,000
TOTAL	**5,361**	**$3,723,000**

This list will help you decide the amount of effort that will be required to observe the assets. Some types of assets are easier to observe than others. For example:

- Equipment is usually a large number of small items.
- Buildings are usually large dollar assets that are easy to observe.
- Land is usually held so long that it is on the books at small book value.

Second, you should prepare a list of assets by department or location. Following is an example of a list of capital assets sorted by department:

	Number of Assets	Gross Book Value (thousands)
Police	200	$2,500
Fire	100	1,500
Public Works	300	2,000
Planning	20	40
Parks & Recreation	100	1,000
Information Technology	1000	5,000
Administration	20	40
TOTAL	**1,740**	**$12,080**

This list can be used to help determine the amount of time each department will need to devote to the observation. In estimating observation effort, consider which departments have historically had difficulty effectively managing their capital assets. Some departments will have a better grip on the location their assets and have reconciled to the accounting records more carefully.

Third, "slice and dice" the capital asset data to identify assets that may need special attention during the observations; for example, (a) assets that have zero book value, (b) assets that have gross book value less than the current capitalization thresholds, and (c) assets acquired in the current fiscal year.

2. Determine Objectives

Before you can inventory fixed assets, you must decide what you will be trying to accomplish during the visits of the various departments and locations. You will, of course, be verifying that recorded assets actually exist, but consider whether you will do the following:

- Identify unrecorded assets.
- Gather non-financial information (e.g., location, asset description, serial number).
- Assess asset condition.
- Affix asset identification tags.
- Take photographs of assets.
- What documentation will be required.

Every objective that you take on increases the amount of time, effort, and cost that it takes to conduct the physical observations, so only important objectives should be undertaken.

Note that physical observations are not an efficient way to test for understatement of recorded capital assets. When assets are found that are not listed in the accounting records, it is hard to know whether the asset has been recorded in a different department or as a part of a larger asset. Also, capitalized assets do not normally cause financial statements to be misleading because understating assets and net position is more conservative. Accordingly, many governments do not attempt to identify unrecorded assets during the physical observations; rather they focus solely on making sure all recorded assets are still on-site. A practical middle-ground approach is to make a list of any very large assets noted during the observation that are not listed separately on the asset list. These assets can be researched later for whether they have been properly capitalized.

It is important to decide up front what types of assets will be tagged. This is discussed more fully below.

3. Clean Up Accounting Records

Capital asset records are frequently inconsistent because, over the decades, different people recorded assets in different ways at different levels of detail, based on different policies. For example, 100 desktop computers bought for $80,000 might be capitalized as 100 lines, one line, or not capitalized because each computer is under the capitalization threshold.

To make capital asset observations as easy as possible, you should remove assets that are not properly capitalized or not necessary. Specifically, remove:

- Studies for assets that were not constructed or that are not identified to a specific asset.
- Repairs and maintenance projects.
- Temporary assets that have been demolished.
- Assets under capitalization thresholds, including any negative amounts, unless they can be reallocated to other capital assets.
- Fully depreciated intangibles (capitalized interest, easements).

After the records have been scrubbed, identify capital asset line items that are components of larger assets. For example, if a building is recorded as 10 different line items, combine them so that you can observe them together.

4. Communicating with Departments

Department staff will play a key role in the observations. They need to identify the location of each asset to the observer; complete paperwork for fixed asset additions, disposal or transfers; update department records; and provide various information about assets. Accordingly, it is important to communicate effectively with them throughout the project. Such communication should include:

- Informing senior department management about the need for the project and its expected scope and timing.
- A kickoff meeting to:
  - Introduce personnel involved.
  - Discuss anticipated problems (e.g., hard to observe assets, disposals, unknown assets, etc.) The list of assets should be sent in advance so the department can prepare for this discussion.

- Describe the process, including anticipated tasks and timing.
- Agree on observation dates.
- Discuss non-capitalized assets.

5. Written Policies and Procedures

If you don't already have written procedures related to capital asset observations, now is the time to develop them. Written procedures help get all employees who are involved in the observations on the same page, knowing their role in the overall process. The written procedures are generally part of the government's overall capital assets policy and procedures. These procedures should include, at a minimum, the following:

- Responsibilities—accounting versus other departments.
- Non-cap assets—whether/how to track assets with gross book value less than capitalization thresholds.
- Asset tagging—which assets are to be tagged, when, and by whom.
- Inventorying—role of annual departmental self-confirmations, frequency and timing of physical inventories, rotation plan.

A sample of written capital asset observation and tagging procedures is available for you to review and tailor to your circumstances at kevinharpercpa.com/resources.html.

6. Physical Inventory Observation Plan

As you plan the physical observations, you will need to develop an observation plan and approach. This plan should consider the following:

Scope: What assets will be observed? Will land, intangibles, and assets below capitalization thresholds be included?

Coverage: Will you observe all fixed assets or a portion based on a rolling multi-year plan or a certain percentage of high value assets to prove the financial statements are not materially misstated? If you haven't observed capital assets in a number of years, it is recommended that 100 percent of assets be observed. In subsequent years, you should observe a portion of the assets on a rotational basis. A rotation plan template is available for download at kevinharpercpa.com/resources.html. This template allows you to document:

- Number of assets by type (helps to estimate number of hours needed to observe and reconcile assets).
- Location of assets (helps to determine sequence of observations).
- Dollar value of assets (helps to determine priority of observations).
- Estimate of the number of hours needed to observe and reconcile assets.

Sequence: In what sequence will you conduct the observations? Locations physically close should be observed together. Departments managed by the same person should be observed together. It is recommended to prioritize (a) departments and locations with high dollar value assets, (b) significant assets that are susceptible to theft, and (c) departments with a history of having difficulty effectively managing their capital assets.

Annual self-confirmation: Will you ask departments to self-confirm their fixed assets at the end of the fiscal year? How much reliance will you place on this self-confirmation (i.e., will it impact how often you conduct a physical observation)? Will you test its accuracy?

You should design the count sheet to be used during the observations to document the information collected and the changes needed to be made to the accounting records. Following is a sample count sheet.

Divison: _____ Contact Email and Phone No: _____
Date(s) of Physical Inventory: _____ Observer(s): _____
Division Contact Person: _____

PER ACCOUNTING RECORDS							OBSERVATION RESULTS				TO DO ITEMS
Count	Asset ID No.	Asset Tag No.	Asset Description	Parent ID No.	Date Capitalized	Gross Book Value	Asset Observed?	Asset Tag No.	Comments	Disposal Justification	Adjustments to G/L
1	11131		BUILDING		8/25/2016	1,000,000	Yes	NA - Building	4 photos	NA	
2	9084		COMPUTER SYSTEM		3/1/2011	200,000	Yes	NA - Software		NA	
3	10726		2018 Ford Explorer		9/1/2014	30,000	Yes	None		NA	Issue asset tag
					TOTAL	$1,230,000					

New Assets (>$5,000 estimated cost):

Count	Asset ID No.	Asset Tag No.	Asset Description	Parent ID No.	Date Capitalized	Gross Book Value	Asset Observed?	Asset Tag No.	Comments	Disposal Justification	Adjustments to G/L
1		681	2014 Ford Explorer		~6/2013	~$25,000	Yes	681		NA	Add to asset list

This count sheet allows documentation of:

- Information about the observation—people, dates, department.
- Information to identify each asset—from the accounting records.
- Information collected by observer during the observation.
- Needed changes to accounting records (e.g., write offs, change asset ID number, change/add tag number, parent ID number, location).
- Unrecorded assets found during the observations.

7. Observe Assets

Following are a few ideas and best practices to consider when conducting physical inventory of capital assets:

Buildings and Improvements

These typically represent a small number of high dollar-value assets. They are typically easy to observe because they don't move, are above ground, and are long lived. The only challenges usually are: (a) to identify all the line items in the capital asset records that relate to a building so that they can be observed together, and (b) to determine whether you will observe each component of the building. In other words, will you consider all components of the building observed when you see a building that is being utilized? You may be able to observe buildings via review of aerial photographs.

Infrastructure

Infrastructure is usually composed of major asset systems such as a power distribution system, sewer system, wastewater system, and roads. These systems are hard to observe because they are underground and/or spread over many miles. Therefore, the strategy for observing these assets should be:

- **Group assets:** Similar to Buildings and Improvements above, you should combine line items in the capital asset records that are components of the same asset. For example, identify all line items that together make up the entire power distribution system. Then decide what level of observation may be adequate to consider the asset "observed." For example, if you turn the light switch on in the various buildings, is that adequate evidence of a working power distribution system or will you put on a hard hat and go underground to observe various components?
- **Geographic Information System (GIS):** If your government uses a GIS, many components of infrastructure will be maintained in that system. Determine whether the system is accurate and up to date enough to rely upon. If so, you may be able to trace assets to the GIS and consider them "observed."
- **Engineering involvement:** It is probable that you will need to rely heavily on a knowledgeable person in public works or engineering to identify infrastructure assets. You may find lots of line items with descriptions like "general construction progress payment #1" or "earth rock fill and grading." The public works director or engineer may recollect details of those projects and help you identify the asset to be observed; or they may describe why the asset no longer exists and should be written off. In some cases, you may need to simply take their word that the asset still exists.

Be creative on ways to prove existence of assets. Remember that a capital assets physical inventory is not "observation" so much as "proof of existence".

Equipment

Equipment is usually a very large number of very small dollar value assets. Therefore, depending on the scope of your observation project, you will likely spend a large amount of your time and effort observing equipment. Most equipment assets are easy to observe. My experience is that about 90 percent of these assets are easily identified by department staff. The other 10 percent of the time, the department disposed of the asset or otherwise can't find it, or they can't identify it from the asset description, or the asset they point out does not match the information in the accounting records. Obviously, you will need to track down these unusual items. However, don't get bogged down in details since the dollar impact won't be large.

I have seen observers spend inordinate time during the observations chasing discrepancies such as which department "owns" the asset, the asset's gross book value, the asset description, reconciling capital asset records to department records, or linking an asset to its parent asset. When these issues come up, I suggest you note them in the count sheet for follow up after the observation is over. It is important to get the observations done expeditiously. Analyzing which items are worthy of follow up is better done when all the discrepancies can be looked at as a group.

Vehicles can be hard to observe because they are usually in use at various locations. Consider using maintenance agreements to "observe" the vehicles. For example, evidence that a vehicle was maintained in the past year is evidence of its existence.

IT assets can be particularly challenging because there is often a large number of them spread throughout the government, and many are identical except for serial numbers. Frequently, the IT department tracks IT assets, and if so, you may be able to rely on their list of IT assets. Just be sure their list of assets is accurate and up-to-date. You may want to trace a few IT assets to their list to confirm its accuracy. If your government owns software that can "ping" all network-connected devices, you will be able to quickly observe most IT hardware. If the IT department has no list and does not have pinging software, you may want to consider engaging temporary staff to help inventory IT assets the first time.

Land

Land is usually composed of a few assets that are very valuable. However, they usually were acquired long ago and therefore carried on the books at small book value. Land can best be "observed" by tracing to ownership records in the county assessor's office.

Intangible Assets

Intangible assets cannot be physically observed. You can usually verify the existence and ownership of easements by tracing to contracts and agreements. Software can be observed by reviewing maintenance agreements and invoices and by asking staff to show you a few working screens in the software.

8. Reconcile Assets to Accounting Records

Following are some of the common challenges (aka "sticky wickets") that you will likely come across during the observations and the subsequent reconciliation of the results to the accounting records. I also provide suggestions about how to address each of the sticky wickets.

Unlocated Assets

The most common sticky wicket is when an asset listed in the accounting records cannot be found by departmental personnel. This happens when:

- The asset was disposed but the accounting department was not notified to remove it from the accounting records.
- The asset description is not clear enough to allow departmental personnel to identify.
- The asset was moved to another location or transferred to another department.

When this happens, you will need to gather further information to allow you to decide how to adjust the accounting records. Specifically, ask:

- Was the asset sold, transferred, traded, or trashed?
- When and why was the asset disposed?
- Does this situation represent a control breakdown? In other words, is this an isolated event or does it indicate there are other similar problems?
- If the asset was disposed, was there a replacement asset and was it properly capitalized?

Sometimes, when you ask these questions, department personnel cannot answer them. What then? How much time and effort should you put in with further research. It depends on:

- Dollar value: If the net book value is low, there is less need to follow up.
- Isolated event: If there is not a control weakness, there is less need to follow up.
- Age: If the asset has not been seen for many years, it is less likely that further research will be fruitful.

In these cases, you will just need to write the asset off. If you can't find it, you can't leave it capitalized in the accounting records. A sample Fixed Asset Disposal Form to use to document approvals for accounting to write off an unlocated asset can be downloaded at kevinharpercpa.com/resources.html.

Unrecorded Assets

You will undoubtedly find assets that are not listed in the accounting records. When this happens, you will need to gather information to know whether/how to record these assets. Ask:

- When was the asset acquired?
- Why was it not capitalized? Is it indicative of a control breakdown?
- Is this a replacement asset for a disposed asset? If so, was the disposed asset written off?

It may be difficult to determine whether an unrecorded asset is in fact not capitalized because:

- It might be capitalized as part of a project or group of assets.
- Many similar assets purchased at once may be capitalized as a single line item.
- It can be difficult to tell what assets are included in line items like "general construction."

A sample Fixed Asset Addition Form that can be used to document approvals for accounting to add an unrecorded asset to the accounting records can be downloaded at kevinharpercpa.com/resources.html

Asset Identification Tags

If your policy is not already clear, you will need to decide what assets should be tagged. How many tags will be used when several assets are capitalized as a single line item in the accounting records? How many tags when one asset has several components that are each capitalized separately in the accounting records?

Generally, you should tag equipment, especially moveable equipment. These are the hardest assets to keep track of and the easiest to be stolen. Generally, the following types of assets are not tagged: intangibles including software, infrastructure, and buildings. You will need to decide whether to tag other assets, such as vehicles, weapons, furniture, immoveable equipment, child assets, and assets under capitalization thresholds.

If assets aren't already tagged, you will need to decide whether to tag them as they are being observed. Once an asset is tagged, it is easier to identify it during future observations. If assets have previously been tagged, you will likely nevertheless find some during your observation that are not tagged. This can be because the tag fell off, was defaced, or never affixed.

Parent/Child Relationships

Many line items in accounting records are not separate assets in their own right. Most modern accounting systems have the capability of linking a child asset to its parent via a Parent ID Number field. The parent and child assets should be observed together. Therefore, you will want to identify parent and child relationships for the observations. Examples of parent and child assets are:

- Construction costs after an asset is placed into service may be capitalized as a separate line item.
- Multiple assets needed to work together such as a battery pack and a portable welder capitalized as separate line items.
- Replacement of part of an asset, such as replacing the engine of a vehicle or a portion of a roadway's paving.

Transfers

When you find an asset during the observations that is not on the asset list, you frequently get this reaction from department personnel. Situations that can lead to assets being recorded in the wrong department include:

- Input error.
- An asset has physically been moved to a different location.
- A vehicle has been recorded in the division that bought it instead of fleet fund.

Internal Controls Over Capital Assets

Following is a list of the primary internal controls that a government should have in place to properly account for its capital assets:

1. Responsibilities for initiating/approving capital expenditures (including leases and repair/maintenance projects) should be segregated from responsibilities for accounting for those transactions (project accounting, property records, and general ledger functions).
2. Approvals by appropriate levels of management and/or elected officials should be required for capital asset transactions. Individuals authorized to initiate capital asset transactions should be identified and the limits of their authority defined.
3. Responsibilities for the project accounting and property records functions should be segregated from the general ledger function.
4. Responsibilities for the project accounting and property records functions should be segregated from the custodial function.
5. Responsibilities for the periodic physical inventories of capital assets should be assigned to individuals who have no custodial or record keeping responsibilities.
6. A separate capital projects budget should be prepared.
7. A subsidiary ledger should be maintained for all capital assets, including those that are self-constructed, donated, purchased, or leased.
8. Physical safeguards over assets should exist.
9. Detailed property records should be periodically compared to existing assets. Periodic inventory of documents evidencing property rights (e.g., deeds, leases, and the like) should be performed. Differences between records and physical observations should be investigated and the accounting records adjusted accordingly.
10. Capital assets should be adequately insured.
11. Equipment should be identified by pre-numbered tags or other means of positive identification.
12. Written procedures and policies should exist to:
    - Distinguish between capital expenditures and repairs/maintenance expenditures.
    - Identify operating budget expenditures to be capitalized.
    - Identify accounting versus departments' responsibilities.
    - Describe whether/how to track non-cap assets.
    - Describe disposal procedures—approvals, notify accounting, sell, donate, advertise, scrap, replacement assets.
    - Describe capitalization thresholds, depreciation methods, level of detail to capitalize (e.g., whether a building will be capitalized as a single asset or each component).
    - Describe procedures to inventory, tag, and reconcile assets to the accounting records.

- An IT asset was recorded in the department where it is being used instead of the IT department.

A sample Fixed Asset Transfer Form that can be used to document approvals before accounting records a transfer can be downloaded at kevinharpercpa.com/resources.html.

Non-cap Assets

GFOA's recommended practices suggest that capital assets with values less than the capitalization thresholds be tracked at the discretion of the departments. Also, some governments have policies that require tracking of certain assets regardless of value, such as weapons and IT assets.

Departments would use their discretion to decide which small assets to track based on the following considerations:

- Track those subject to theft or loss.
- Track those with higher dollar value.
- Track those with legal or compliance requirements. For example, grant funded assets may need to be tracked separately so that they are properly reported to grantor when disposed.
- Other management need or discretion.

Assets Held by Othersor Owned by Others

It will be helpful to identify any assets that are not on-site before beginning the observations. You may need to arrange an observation with another organization or obtain a written confirmation of assets they have in their possession. Examples of assets not on-site are:

- Assets in off-site storage.
- Equipment purchased but not yet received.
- Equipment loaned to others.

It will also be helpful to identify any assets on-site that are not owned. In these cases, you will need to make sure not to capitalize them as unrecorded assets. Examples of unowned assets are:

- Equipment provided by contractors.
- Rented equipment.
- Heavy equipment borrowed from another government.
- Jointly constructed assets capitalized by another entity.

A well-planned physical observation of capital assets will avoid most of these sticky wickets. Give capital assets the respect they deserve by conducting periodic physical observations and reconciling the results to the accounting records. It is a large task the first time you observe all your assets, but usually is manageable in future years when observations are done on a rotational basis. PM

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