CHAPTER 12
AUDITING LONG-LIVED ASSETS: ACQUISITION, USE, IMPAIRMENT, AND DISPOSAL
LEARNING OBJECTIVES

1. Identify the significant accounts, disclosures, and relevant assertions in auditing long-lived assets
2. Identify and assess inherent risks of material misstatement associated with long-lived assets
3. Identify and assess fraud risks of material misstatement associated with long-lived assets
4. Identify and assess control risks of material misstatement associated with long-lived assets
LEARNING OBJECTIVES

5. Describe how to use preliminary analytical procedures to identify possible material misstatements associated with long-lived assets

6. Determine appropriate responses to identified risks of material misstatement in auditing long-lived assets

7. Determine appropriate tests of controls and consider the results of tests of controls in auditing long-lived assets
LEARNING OBJECTIVES

8. Determine and apply sufficient appropriate substantive audit procedures in auditing long-lived assets

9. Apply the frameworks for professional decision making and ethical decision making to issues involving the audit of long-lived assets
THE AUDIT OPINION FORMULATION PROCESS

I. Making Client Acceptance and Continuance Decisions
   Chapter 14

II. Performing Risk Assessment
    Chapters 3, 7 and 9–13

III. Obtaining Evidence about Internal Control Operating Effectiveness
     Chapters 8–13 and 16

IV. Obtaining Substantive Evidence about Accounts, Disclosures and Assertions
    Chapters 8–13 and 16

V. Completing the Audit and Making Reporting Decisions
   Chapters 14 and 15

The Auditing Profession, the Risk of Fraud and Mechanisms to Address Fraud: Regulation, Corporate Governance, and Audit Quality
   Chapters 1 and 2

Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions
   Chapter 4

The Audit Opinion Formulation Process and A Framework for Obtaining Audit Evidence
   Chapters 5 and 6
PROFESSIONAL JUDGMENT IN CONTEXT - ACCOUNTING PROBLEMS RELATED TO LONG-LIVED ASSETS AT IGNITE RESTAURANT GROUP

- Ignite Restaurant Group, after going public in 2012, needed to restate its financial statements to correct errors related to treatment of certain leases.
- IRG planned a fixed-asset accounting review assessing historical asset additions, dispositions, useful lives, and depreciation from 2006 through 2012.
- IRG reviewed the effectiveness of its internal controls over leases and other fixed assets.
• What types of misstatements occur in long-lived asset accounts? (LO 1, 2, 3)
• What might motivate management to misstate long-lived asset accounts? (LO 3)
• What controls should be in place to mitigate misstatements associated with long-lived assets? (LO 4)
• What procedures should an auditor perform when auditing long-lived asset accounts? (LO 5, 6, 7, 8)
LEARNING OBJECTIVE 1

IDENTIFY THE SIGNIFICANT ACCOUNTS, DISCLOSURES, AND RELEVANT ASSERTIONS IN AUDITING LONG-LIVED ASSETS
SIGNIFICANT ACCOUNTS, DISCLOSURES, AND RELEVANT ASSERTIONS

• **Long-lived assets**: Noncurrent assets that are used over multiple operating cycles and include tangible and intangible assets
  
  • **Tangible assets**: Have a physical form
    • Machinery, buildings, and land
  
  • **Intangible assets**: Have a nonphysical form
    • Patents, trademarks, copyrights, and brand recognition
SIGNIFICANT ACCOUNTS, DISCLOSURES, AND RELEVANT ASSERTIONS

- Other accounts associated with long-lived assets
  - Related depreciation or impairment expense
  - Related gains caused by disposals
  - Related losses caused by disposals or impairments
  - Accumulated depreciation account
- Depletion expense: Associated with the extraction of natural resources
- Amortization expense: Process of expensing acquisition cost minus residual value of intangible assets over their estimated useful economic life
ACTIVITIES IN THE LONG-LIVED ASSET ACQUISITION AND PAYMENT CYCLE

- Acquisition of long-lived assets is based on organization’s planning for long-term productive capacity
  - Such assets are requested and purchased
- Portion of the asset’s cost is then allocated as an expense depending on type of asset
  - Depreciation
  - Amortization
  - Depletion
ACTIVITIES IN THE LONG-LIVED ASSET ACQUISITION AND PAYMENT CYCLE

• The long-lived tangible and intangible assets are reviewed for possible asset impairment
  • When appropriate, asset is recognized as an impairment loss and written down to its fair value
• In situations of disposal of assets, companies determine and record the gain or loss on the asset disposal
## RELEVANT FINANCIAL STATEMENT ASSERTIONS

<table>
<thead>
<tr>
<th>Existence or occurrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Long-lived assets exist at the balance sheet date</td>
</tr>
<tr>
<td>• The focus is on additions during the year</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Completeness</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Long-lived asset account balances include all relevant transactions that have taken place during the period</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rights and obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Organization has ownership rights for the long-lived assets as of balance sheet date</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Valuation or allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The recorded balances reflect the balances in accordance with GAAP</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Presentation and disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Long-lived asset balance is reflected on balance sheet in noncurrent section</td>
</tr>
<tr>
<td>• The disclosures for depreciation methods and capital lease terms are adequate</td>
</tr>
</tbody>
</table>
LEARNING OBJECTIVE 2

IDENTIFY AND ASSESS INHERENT RISKS OF MATERIAL MISSTATEMENT ASSOCIATED WITH LONG-LIVED ASSETS
IDENTIFYING INHERENT RISKS

• **Asset impairment**: Management’s recognition that a significant portion of fixed assets is no longer as productive as had originally been expected
  - When assets are so impaired, they should be written down to their expected economic value
• Factors associated with inherent risk related to asset impairment
  - Management is not interested in identifying and writing down assets
  - Management wants to write down every potentially impaired asset to a minimum realizable value
IDENTIFYING INHERENT RISKS

• Determining asset impairment requires:
  • Good information system
  • Systematic process and effective controls
  • Professional judgment
• Incomplete recording of asset disposals
• Obsolescence of assets
• Incorrect recording of assets due to complex ownership structures
• Amortization that does not reflect economic impairment
AUDITOR’S AWARENESS OF INHERENT RISKS

- Knowledge of client’s business, industry trends and technological advances
- Review of various documents, including:
  - Business plan for major acquisitions or changes in the way a company conducts its business
  - Major contracts regarding capital investments or joint ventures with other companies
  - Minutes of board of directors’ meetings
  - Company filings with the SEC describing company actions, risks, and strategies
AUDITING IN PRACTICE - AUDITING OF LONG-LIVED ASSETS DOES HAVE RISKS

• Audit of long-lived assets is mechanical in some settings
• However, the auditor must understand
  • Client’s business strategy
  • Current economic conditions
  • Potential changes in the economic value of assets
• Serious mistakes can be made if auditors always consider long-lived assets a low-risk audit area
INHERENT RISKS ASSOCIATED WITH NATURAL RESOURCES AND INTANGIBLE ASSETS

Natural Resources

• Difficult to identify costs associated with discovery
• Difficult to estimate commercially available resources to be used in determining a depletion rate
• Difficult to estimate reclamation cost when the client restores the property

Intangible Assets

• Determination of cost not straightforward
• Legal costs for obtaining and defending a patent are capital expenditures
• Cost of patents should be amortized over the lesser of their legal life or their estimated useful life
LEARNING OBJECTIVE 3

IDENTIFY AND ASSESS FRAUD RISKS OF MATERIAL MISSTATEMENT ASSOCIATED WITH LONG-LIVED ASSETS
IDENTIFYING FRAUD RISK FACTORS

- Overstatement of assets through overvaluing existing assets
- Sales of assets not recorded, and proceeds misappropriated
- Assets that have been sold not removed from the books
- Inappropriate residual values assigned to the assets, resulting in miscalculation of depreciation
IDENTIFYING FRAUD RISK FACTORS

- Amortization of intangible assets miscalculated
- Costs that should have been expensed improperly capitalized
- Impairment losses on long-lived assets not recognized
- Fair value estimates unreasonable
LEARNING OBJECTIVE 4

IDENTIFY AND ASSESS CONTROL RISKS OF MATERIAL MISSTATEMENT ASSOCIATED WITH LONG-LIVED ASSETS
TYPICAL CONTROLS AFFECTING MULTIPLE ASSERTIONS FOR LONG-LIVED ASSETS

- Formal budgeting process with appropriate follow-up variance analysis
- Written policies for acquisition and disposals of long-lived assets, including required approvals
- Limited physical access to assets, where appropriate
- Periodic comparison of physical assets to subsidiary records
- Periodic reconciliations of subsidiary records with the general ledger
AUDITING IN PRACTICE - WORLDCOM

- WorldCom’s management improperly released $984 million in depreciation reserves to increase pretax earnings by decreasing depreciation expense or increasing miscellaneous income.
- Depreciation reserves were created in a variety of ways:
  - Cost of equipment returned to vendors for credit after being placed in service was credited to the reserve.
  - Unsupported additions to an asset account were recorded with a corresponding increase in the reserve.
AUDITING IN PRACTICE - WASTE MANAGEMENT

• The company’s management increased estimated useful lives of all the depreciable assets to increase reported net income
• Auditors never questioned the change
• SEC pointed out these estimated useful lives simply were not realistic
• Waste Management had misstated earnings of $3.5 billion
CONTROLS RELATED TO EXISTENCE/OCCURRENCE AND VALUATION FOR TANGIBLE ASSETS

• Identify existing assets, inventory them, and reconcile the physical asset inventory with the property ledger on a periodic basis
• Provide reasonable assurance that all purchases are authorized and properly valued
• Appropriately classifying new equipment according to its expected use and valuation
• Periodically reassess appropriateness of depreciation categories
CONTROLS RELATED TO EXISTENCE/OCCURRENCE AND VALUATION FOR TANGIBLE ASSETS

• Identify obsolete equipment and write the equipment down to scrap value
• Review management strategy and systematically assess impairment of assets
• Use serial numbered asset tags, with bar codes for tracking the location, quantity, condition, maintenance, and depreciation status of assets
MANAGEMENT’ S CONTROLS RELATED TO ASSET IMPAIRMENT JUDGMENTS

• Systematically identify assets that are not currently in use
• Projections of future cash flows, by reporting unit, that are based on management’ s strategic plans and economic conditions
• Systematically develop current market values of similar assets prepared by the client
CONTROLS OVER NATURAL RESOURCES

- Most established natural resource companies:
  - Develop procedures and associated internal controls for identifying costs
  - Use geologists to establish an estimate of reserves contained in a new discovery
  - Reassess the amount of reserves as more information becomes available during the course of mining, harvesting, or extracting resources
CONTROLS RELATED TO VALUATION AND PRESENTATION/DISCLOSURE FOR INTANGIBLE ASSETS

• Provide reasonable assurance that decisions are appropriately made as to when to capitalize or expense research and development expenditures
• Develop amortization schedules reflecting the remaining useful life of patents or copyrights associated with the asset
• Identify and account for intangible-asset impairments
EXHIBIT 12.2 - EXAMPLES OF CONTROLS OVER INTANGIBLE LONG-LIVED ASSETS

- Management authorizations are required for intangible asset transactions.
- Documentation regarding intangible assets should be maintained, and such documentation should include:
  - Manner of acquisition (for example, purchased or developed internally)
  - Basis for the capitalized amount
  - Expected period of benefit
  - Amortization method
- Amortization periods and calculations should be approved and periodically reviewed by appropriate personnel.
DOCUMENTING CONTROLS

• Auditors need to document their understanding of internal controls for integrated and financial statement only audits

• Auditors can provide documentation in various formats
  • Control matrix
  • Control risk assessment
  • Questionnaire
  • Memo
LEARNING OBJECTIVE 5

DESCRIBE HOW TO USE PRELIMINARY ANALYTICAL PROCEDURES TO IDENTIFY POSSIBLE MATERIAL MISSTATEMENTS ASSOCIATED WITH LONG-LIVED ASSETS
RATIO AND TREND ANALYSES

• Review and analyze gains/losses on disposals of equipment
• Perform an overall estimate of depreciation expense
• Compare capital expenditures with the client’s capital budget
• Compare depreciable lives for various asset categories with those of the industry
• Compare the asset and related expense account balances in the current period to similar items in the prior audit
RATIOS THAT THE AUDITOR SHOULD PLAN TO REVIEW

• Ratio of depreciation expense to total depreciable long-lived tangible assets
• Ratio of repairs and maintenance expense to total depreciable long-lived tangible assets
• Ratio analysis should involve comparison of the unaudited financial statements with both past results and industry trends
RATIO AND TREND ANALYSES

If preliminary analytical procedures do not identify any unexpected relationships:

Auditor would conclude that there is not a heightened risk of material misstatements in these accounts.

If unusual or unexpected relationships exist in preliminary analytical procedures:

Planned audit procedures would be adjusted to address the potential material misstatements.
LEARNING OBJECTIVE 6

DETERMINE APPROPRIATE RESPONSES TO IDENTIFIED RISKS OF MATERIAL MISSTATEMENT IN AUDITING LONG-LIVED ASSETS
RESPONDING TO IDENTIFIED RISKS OF MATERIAL MISSTATEMENT

• Developing an audit approach that contains tests of controls (if applicable) and substantive procedures
• If client’s controls related to long-lived assets are effective auditor can rely on substantive analytical procedures
• Auditors should customize their standardized audit program based on the assessment of risk of material misstatement
EXHIBIT 12.3 - PANEL A: SUFFICIENCY OF EVIDENCE FOR EXISTENCE OF EQUIPMENT
EXHIBIT 12.3 - PANEL B: APPROACHES TO OBTAINING AUDIT EVIDENCE FOR EXISTENCE OF EQUIPMENT

Client A—Low Risk
- 30% tests of details
- 40% analytics
- 30% tests of controls

Client B—High Risk
- 50% tests of details
- 30% analytics
- 20% tests of controls
ADDITIONAL CONSIDERATIONS

• Organizations having only a few assets of relatively high value
  • Use of substantive approach, using tests of details, for obtaining evidence rather than performing tests of controls

• Organizations having a high volume of long-lived asset transactions
  • Perform tests of controls to support a moderate- or low-assessed level of control risk and then reduce substantive testing
DETERMINE APPROPRIATE TESTS OF CONTROLS AND CONSIDER THE RESULTS OF TESTS OF CONTROLS IN AUDITING LONG-LIVED ASSETS
SELECTING CONTROLS TO TEST AND PERFORMING TESTS OF CONTROLS

• Auditors select both entity-wide and transaction controls for testing

• Tests of transaction controls
  • Inquiry of personnel performing the control
  • Observation of the control being performed
  • Inspection of documentation confirming that the control has been performed
  • Reperformance of the control by the auditor testing the control
PERFORMING TESTS OF CONTROLS

• Inquiry - Inquire about the nature of training to a select sample of personnel
• Observation - Observe property management actions in process
• Inspection of documentation - Review documentation showing completion of the training
OUTCOMES OF THE RESULTS OF TESTS OF CONTROLS

- Auditor analyzes results of tests of controls
  - If control deficiencies are identified:
    - Assess those deficiencies to determine their severity
    - Modify the preliminary control risk assessment
    - Document the implications of the control deficiencies
    - Determine whether the preliminary assessment of control risk as low is still appropriate
    - Determine the extent that controls can provide evidence on the correctness of account balances
    - Determine planned substantive audit procedures
  - If no control deficiencies are identified:
LEARNING OBJECTIVE 8

DETERMINE AND APPLY SUFFICIENT APPROPRIATE SUBSTANTIVE AUDIT PROCEDURES IN AUDITING LONG-LIVED ASSETS
ASSURANCES REQUIRED BY AUDITOR IN
PERFORMING SUBSTANTIVE PROCEDURES

• Long-lived assets reflected in balance sheet physically exist
• Organization has rights of ownership to recorded long-lived assets
• Long-lived assets include all relevant items, including those that are purchased, contributed, constructed in-house or by third parties, and leases meeting the criteria for capital leases
• Long-lived asset additions are recorded correctly
ASSURANCES REQUIRED BY AUDITOR IN PERFORMING SUBSTANTIVE PROCEDURES

• Items to be capitalized are identified and distinguished from repairs and maintenance expense items
• Depreciation/amortization/depletion calculations are made and based on appropriate estimated useful lives and methods
• Retirements, trade-ins, and unused property and equipment are identified and recorded correctly
ASSURANCES REQUIRED BY AUDITOR IN PERFORMING SUBSTANTIVE PROCEDURES

• Long-lived assets and related expenses are appropriately presented in the financial statements with adequate disclosures

• Fraudulent transactions are not included in the financial statements
## EXHIBIT 12.4 - MANAGEMENT ASSERTIONS AND SUBSTANTIVE PROCEDURES FOR LONG-LIVED ASSETS AND RELATED EXPENSES

<table>
<thead>
<tr>
<th>Management Assertion</th>
<th>Substantive Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence/occurrence—Recorded long-lived assets exist.</td>
<td>1. Perform substantive analytical procedures.</td>
</tr>
<tr>
<td></td>
<td>2. Inspect tangible assets.</td>
</tr>
<tr>
<td></td>
<td>3. Vouch additions to supporting documentation.</td>
</tr>
<tr>
<td></td>
<td>4. Review account activity for the year and vouch significant items.</td>
</tr>
<tr>
<td>Completeness—All long-lived assets have been recorded.</td>
<td>1. Perform substantive analytical procedures.</td>
</tr>
<tr>
<td></td>
<td>2. Review capitalization policy to assure that all significant capital expenditures are properly capitalized.</td>
</tr>
<tr>
<td></td>
<td>3. Review entries to repair and maintenance expense to determine whether some items should have been capitalized.</td>
</tr>
<tr>
<td>Rights/obligations—The organization has legal title or similar rights of ownership to recorded long-lived assets.</td>
<td>1. Inquire of management as to whether long-lived assets have been pledged as collateral.</td>
</tr>
<tr>
<td></td>
<td>2. Examine documents of title.</td>
</tr>
<tr>
<td>Management Assertion</td>
<td>Substantive Procedure</td>
</tr>
<tr>
<td>----------------------</td>
<td>-----------------------</td>
</tr>
</tbody>
</table>
| **Valuation/allocation**—Long-lived assets are properly valued. | 1. Review depreciation policy and test depreciation calculations.  
2. Inquire of management about assets that are idle.  
3. Test amortization expense.  
4. Assess the reasonableness of carrying amounts and unamortized balances.  
5. Inquire of management as to whether there has been any permanent impairment of assets.  
6. Assess management’s impairment estimates. |
| **Presentation/disclosure**—Long-lived assets and related expenses, such as depreciation, amortization, or depletion, are appropriately presented in the financial statements with adequate disclosures. | 1. Review presentation and disclosure in the financial statements and determine whether they are in accordance with GAAP. |
SUBSTANTIVE TESTS OF DETAILS FOR TANGIBLE ASSETS - TESTING CURRENT PERIOD ADDITIONS

• Auditor examines supporting documentation of individual long-lived asset transactions by examining a schedule of additions
• After the schedule is agreed to the general ledger, auditor selects sample items for testing
• Auditor determines that capitalized additions were appropriate and that none of them should have been expensed as repairs and maintenance or other costs
If auditor perceives that misstatement risks are applicable to a particular client:

- Procedure adjusted by requesting the client to prepare a schedule of fixed-asset additions and repair and maintenance expense transactions
- Selected transactions from both schedules can be vouched to:
  - Vendor invoices
  - Work orders
  - Other supporting evidence
AUDITING IN PRACTICE - IMPROPER CAPITALIZATION OF OPERATING EXPENSES

• Safety-Kleen Corporation’s CFO, controller, and vice president of accounting orchestrated an accounting fraud to overstate SK’s revenue and earnings
• One element of the fraud involved the improper capitalization and deferral of operating expenses
• Safety-Kleen filed for bankruptcy
  • SEC pursued the company and the individuals involved
## EXHIBIT 12.5 - SCHEDULE OF LONG-LIVED ASSET ADDITIONS AND DISPOSALS

**Burke Enterprises**  
**Long-Lived Asset Additions and Disposals—Equipment**  
**December 31, 2013**

<table>
<thead>
<tr>
<th>Description</th>
<th>Date Purchased</th>
<th>Beginning Balance</th>
<th>Additions</th>
<th>Disposals</th>
<th>Ending Balance</th>
<th>Beginning Balance</th>
<th>Depreciation Expense</th>
<th>Disposals</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>Various</td>
<td>124,350</td>
<td></td>
<td></td>
<td>124,350</td>
<td>33,429</td>
<td>12,435†</td>
<td></td>
<td>45,864</td>
</tr>
<tr>
<td>Additions:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>40” lathe</td>
<td>10/30/13</td>
<td></td>
<td>–0–</td>
<td>9,852†</td>
<td>9,852</td>
<td>–0–</td>
<td>1,250‡</td>
<td></td>
<td>1,250</td>
</tr>
<tr>
<td>1040 press</td>
<td>3/25/13</td>
<td></td>
<td>–0–</td>
<td>18,956†</td>
<td>18,956</td>
<td>–0–</td>
<td>1,895‡</td>
<td></td>
<td>1,895</td>
</tr>
<tr>
<td>60” lathe</td>
<td>5/29/13</td>
<td></td>
<td>–0–</td>
<td>13,903†</td>
<td>13,903</td>
<td>–0–</td>
<td>950‡</td>
<td></td>
<td>950</td>
</tr>
<tr>
<td>Disposals:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fork lift</td>
<td>6/2/10</td>
<td></td>
<td></td>
<td>7,881§</td>
<td>(7,881)</td>
<td></td>
<td></td>
<td>3,703</td>
<td>(3,703)</td>
</tr>
<tr>
<td>Computer</td>
<td>7/2/11</td>
<td></td>
<td></td>
<td>3,300§</td>
<td>(3,300)</td>
<td></td>
<td></td>
<td>2,625</td>
<td>(2,625)</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>124,350³</td>
<td>42,711**</td>
<td>11,181**</td>
<td>170,880³*††</td>
<td>33,429³</td>
<td>16,530**</td>
<td>6,378**</td>
<td>43,581³††</td>
</tr>
</tbody>
</table>

* Estimated from last year; includes one-half year depreciation for assets disposed of during the year. See Working Paper PPE-4 for calculation of the estimate.  
† Recalculated; noting that depreciation is in accordance with company policy and asset classification estimated economic life.  
‡ Traced to asset ledger and verified that equipment had been removed. Examined sales document or scrap disposal document for the disposal of the asset.  
§ Traced to December 31, 2012, audit documentation.  
** Footed/cross footed.  
†† Traced to trial balance.
SUBSTANTIVE TESTS OF DETAILS FOR TANGIBLE ASSET - TESTING CURRENT PERIOD DELETIONS

• Auditor should:
  • Trace original cost of item and its accumulated depreciation to supporting documentation
  • Recompute any gain or loss to determine whether it is accounted for in conformity with GAAP
  • Perform procedures to search for any unrecorded disposals
SUBSTANTIVE PROCEDURES RELATED TO DEPRECIATION EXPENSE AND ACCUMULATED DEPRECIATION FOR TANGIBLE ASSETS

• Objective in testing depreciation is to determine:
  • Whether the client is following a consistent depreciation policy and whether the client’s calculations are accurate
  • Whether management’s estimates are reasonable
LOW RISK: PERFORM SUBSTANTIVE ANALYTICAL PROCEDURES

• To determine reasonableness of current charges to the accounts, analytical procedures could incorporate a number of ratios and an overall test of reasonableness

• Ratios can include:
  • Current depreciation expense as a percentage of the previous-year depreciation expense
LOW RISK: PERFORM SUBSTANTIVE ANALYTICAL PROCEDURES

- Fixed assets as a percentage of previous-year assets
- Depreciation expense as a percentage of assets each year
- Accumulated depreciation as a percentage of gross assets each year
- Average age of assets
HIGH RISK: PERFORM SUBSTANTIVE TESTS OF DETAILS

• Perform detailed tests of depreciation by starting with the fixed-asset ledger
• GAS used to foot the ledger and match it to the general ledger
• Sample of items contained in detailed property ledger taken to recalculate depreciation for items chosen
  • Samples selected considering materiality and risk and based on recorded depreciation
  • Differences are projected to the population as a whole
HIGH RISK: PERFORM SUBSTANTIVE TESTS OF DETAILS

• If there are significant differences, the auditor:
  • Determines root cause of problem
  • Request that the client correct the problem
• GAS is used to identify all entries into the depreciation and accumulated depreciation accounts coming from other than normal depreciation entries and asset disposals
EVALUATING CHANGES IN DEPRECIATION METHODS

• Auditor makes sure that depreciation methods used are consistent with the prior year
  • Unless client has reasonable justification for changing methods

• Auditor reads notes of the financial statements to be sure that all relevant information regarding changes has been disclosed
AUDIT PROCEDURES FOR DETERMINING THE COST OF NATURAL RESOURCES

• Test the capitalization of all new natural resources
• Verify the costs by examining documents including client’s own process of documenting all the costs of exploration and drilling
• Substantiate the amount of items sold during the year
SUBSTANTIVE TESTS OF DETAILS FOR INTANGIBLE ASSETS

• Determine that such assets exist by reviewing appropriate documentation
• Determine that the intangible assets are owned by the organization by inspecting relevant documentation
• Test management’s calculation of any gain or loss on disposal of assets and determine proper reduction of carrying amounts
SUBSTANTIVE TESTS OF DETAILS FOR INTANGIBLE ASSETS

• Determine whether amortization expense is accurate and whether amortization policy and useful lives are reasonable and consistent with prior years

• Inquire of management whether circumstances indicate that the carrying amounts of intangibles may not be recoverable
EXHIBIT 12.6 - CIRCUMSTANCES INDICATING POTENTIAL IMPAIRMENT OF INTANGIBLE ASSETS

- A change in circumstances, such as the legal environment or business climate, that could affect the asset’s value or cause an adverse action by a regulator
- An accumulation of costs that are significantly in excess of the amount originally expected to be needed to acquire or construct the asset
- Losses or projections indicating continuing losses associated with an asset used to generate revenue
- A current expectation that, more likely than not, an asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.
SUBSTANTIVE PROCEDURES RELATED TO ASSET IMPAIRMENT

• Auditor needs reasonable assurance that:
  • Long-lived assets are valued at their economic benefit to the organization
  • When value has been impaired, the organization has written down the asset
• If there is evidence that an asset has been impaired, auditor needs to address the valuation issue
  • Understand the process for assessing impairment
  • Evaluate reasonableness of management’s assumptions
AUDITING IN PRACTICE - PCAOB IDENTIFIES AUDIT DEFICIENCIES RELATED TO ASSET IMPAIRMENT ISSUES

• 2010 PCAOB inspection report of Grant Thornton LLP
  • The firm failed to evaluate the effects on the financial statements of the failure to test the assets for impairment

• 2010 PCAOB inspection report of PricewaterhouseCoopers LLP
  • There was no evidence in audit documentation that the firm had tested certain assumptions such as all machinery and equipment of more than four years old would have a fair value of zero
AUDITING IN PRACTICE - PCAOB IDENTIFIES AUDIT DEFICIENCIES RELATED TO ASSET IMPAIRMENT ISSUES

• 2010 PCAOB inspection report of McGladrey & Pullen LLP
  • The firm failed to:
    • Evaluate fair value, useful life, and potential impairment of an indefinite-lived intangible asset related to a marketing agreement
    • Test the fair value that issuer assigned to intangible asset
    • Consider the fact that marketing agreement allowed issuer and counterparty to terminate the agreement
    • Consider potential indicators of impairment
SUBSTANTIVE PROCEDURES RELATED TO LEASES

• Obtain copies of lease agreements, read the agreements, and develop a schedule of lease expenditures
• Review lease expense account, select entries to the account, and determine if there are entries that are not covered by leases obtained from client
• Determine if expenses are properly accounted for
• Review relevant criteria from the FASB’s codified standards (ASC) to determine which leases meet the requirement of capital leases
SUBSTANTIVE PROCEDURES RELATED TO LEASES

• For all capital leases, determine that assets and lease obligations are recorded at their present value
• Develop a schedule of all future lease obligations or determine whether client’s schedule is correct by referring to underlying lease agreements
• Review client’s disclosure of lease obligations to determine that it is in accordance with GAAP
PERFORMING SUBSTANTIVE FRAUD-RELATED PROCEDURES

- Physically inspect tangible assets and agree serial numbers with supporting documentation
- Request client to perform a complete inventory of long-lived assets at year end
- Scrutinize appraisals and other specialist reports that seem out of line with reasonable expectations, and challenge the underlying assumptions
PERFORMING SUBSTANTIVE FRAUD-RELATED PROCEDURES

• Use the work of a specialist for asset valuations and impairments
• When vouching long-lived asset additions, accept only original invoices, purchase orders, receiving reports or similar supporting documentation
• Confirm terms of significant additions of property or intangibles with other parties involved
DOCUMENTING SUBSTANTIVE PROCEDURES

• For tangible assets
  • Summary schedule showing:
    • Beginning balances
    • Additions and deletions
    • Ending balances for the asset account and for accumulated depreciation
  • Identification of the specific items tested
• For intangible assets - Evidence supporting review of the reasonableness of their continuing value