Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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Contents of the Curriculum

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PART B: BUSINESS PROCESSES AND INTERNAL CONTROLS

B.5: Property Plant & Equipment Management

Doing business or running an organization is a series of activities/multiple activities carried out to achieve business goals/objectives. Activities carried out on 'ACQUISITION & DISPOSAL OF PPE' is one such prime activity carried out by almost all of the organizations as PPE is major asset which involves series of tasks pertaining to the organization.

Notes:

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Chapter contents

B.5.1. What is property, plant and equipment?

Property, plant and equipment (PPE) are the capital assets (non-current assets) of a business

Property, plant and equipment (PPE) are capital assets of a business. In accounting, they are called non-current tangible assets.

- A non-current asset is an asset that is acquired and used in the business with a view to earning profits over a period of several years.
- Spending to acquire PPE or non-current assets is capital expenditure

Examples of PPE are:

- Land and buildings (property, real estate)
- Plant, machinery and other equipment
- Motor vehicles

B.5.2. Controlling capital expenditure

Total capital expenditure on PPE is controlled by means of a CAPEX budget and formal procedures for authorizing individual items of capital expenditure

The CAPEX budget

Within a business organization, there is often competing demand for available funds for capital expenditure. The acquisition of new capital items can help a business to grow, and many different divisions or departments within an organization usually want to be given funds to buy items of PPE.

However, business organizations have limited funds available for capital expenditure. In view of the large amounts of spending that may be involved, it is important to have a process for deciding which parts of the business should be given funds to buy PPE

Approval of spending on PPE

Discretionary capital spending should be financially justified, using evaluation techniques such as the net present value (NPV) method

Each purchase of PPE should be approved individually. Although managers may have a capital spending allocation within the CAPEX budget, they cannot spend money unless the spending proposition has been assessed and approved. The approval of spending should be recorded, including the reasons why the purchase is considered justifiable

Feature of capital spending	Approval process
Some items of PPE may be purchased in large quantities, often as replacements for items of PPE that have reached the end of their useful life.	For example, a department may have a programme of replacing laptop computers or desktop computers every ten years, and there may be a rolling programme of replacing 10% of the computers every year. This type of spending should not require financial justification but would need to be within the department's capital budget spending limit.
Some items of PPE may be purchased infrequently and may have a substantial cost. Some may be investments in new business activities rather than replacements for ageing PPE items. They are not usually for essential replacements, and so are 'optional' capital spending.	Spending on these capital investments should undergo financial analysis, and the purchase should be justified financially. One technique of evaluation proposed capital investments is the net present value (NPV) method of discounted cash flow (DCF).

Capital expenditure authorization form

Acquisitions of non-current assets should be authorized on a capital expenditure authorization form.

Capital expenditure over a certain amount must normally be authorized by the directors of the company and decisions about major capital projects should be recorded in the minutes of board meetings. A document called a capital expenditure authorization form (or some similar name) is used to record formal authorization of an asset purchase.

The capital expenditure authorization form should show the prior authority for capital expenditure and indicate the approved method of funding, outright purchase or lease

CAPITAL EXPENDITURE AUTHORISATION FORM

Company/Division.....

Description of item and reason for purchase.....

.....

.....

Supplier.....

Cost.....

Was this the cheapest quote obtained (if not state reason)?

.....

.....

Authorised by:.....

Counter-authorised (if over Rs. 200,000) by:.....

Purchase/lease*.....

Terms of lease.....

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* delete as applicable

B.5.3. Vendor selection and tender procedures

In large capital purchases, an organization may invite several potential suppliers to submit a tender/bid for the contract

The purpose of the vendor selection process is simply to decide which supplier should be given the contract

Tender process

The organization should identify a number of suppliers who seem to have the resources and ability to deliver the capital items required. These suppliers should be asked whether they would be interested in bidding for the contract in a tender process

Selecting the preferred bid

The tenders or bids from the suppliers are assessed, and the preferred supplier is selected on the basis of the tender. A preferred bid may be recommended by the managers responsible for the tender process, but the final decision should be made at an appropriate level of management. Very large contracts, for example, may require approval by the board of directors

Risk of bribery in the tender process

A risk in the tender process for a major capital spending item is that a supplier may try to win the support of a decision maker in the buying organization by offering a bribe. Offering and accepting bribes is unethical as well as illegal

The purchase and delivery process

The process for delivery of PPE items from a supplier can vary. The buying organization may establish a project team to work with the supplier on production and delivery and installation of the PPE item

Recording purchases of PPE items

When capital items are delivered by the supplier, the new capital asset is recorded in two files:

- In a non-current asset account in the bookkeeping system
- In a fixed asset register

B.5.4. Recording non-current assets in the bookkeeping system

Spending on a non-current asset is capitalized, and the cost is spread over the expected useful life of the asset by means of depreciation charges

The non-current asset is recorded in a non-current asset account by the accounting department. There are different non-current asset accounts: for example, there will be different accounts for property, plant and equipment, and motor vehicles

Capitalization

The term 'capitalization' means that a cost is treated as a capital cost rather than as a 'revenue expenditure'. The benefits to the organization will be obtained over a number of years. Consequently, for the purpose of measuring annual expenditure and profit, capital costs should be spread over their expected useful life

An organization should have guidelines for deciding which assets are non-current or fixed and so should be capitalized, and which purchased assets are 'revenue expenditure' that should be recorded as inventory in current assets. These guidelines should comply with the requirements of the accounting standard on property, plant and equipment (LKAS 16)

Every non-current asset eventually wears out over time: the only exception is land. Machines, cars and other vehicles, equipment and even buildings do not last forever.

When a business acquires a non-current asset, it will have some idea about how long the asset's useful life is likely to be and might decide to do one of three things.

(a) It may keep on using the non-current asset until it becomes completely worn out, useless and worthless.

(b) It may decide to sell off the asset at the end of its useful life either by selling it as a secondhand item or as scrap.

(c) It may decide to sell off the asset before the end of its useful life

The amount of depreciation deducted from the cost of a non-current asset to arrive at its net book value will build up (or 'accumulate') over time, as more depreciation is charged in each successive accounting period. This accumulated depreciation is an allowance to provide for the fall in value of the non-current asset.

In the accounting system, non-current assets are recorded as follows.

- As an asset at cost. (There may be a subsequent adjustment in the asset value, but we shall ignore this possibility here.)
- A record is kept of the accumulated depreciation on the asset, since it was acquired.
- An annual charge for depreciation is made against profit: this annual charge also adds to the accumulated depreciation.
- The net book value of the asset can be calculated by deducting the accumulated depreciation from the cost of the asset

B.5.5. Non-current asset register

A record of non-current asset acquisitions (and disposals) is recorded initially in a non-current assets register. This is a record of all the non-current assets held by the organization

A non-current asset register is kept mainly for internal purposes. It is not part of the bookkeeping system but it is used by accountants to calculate depreciation charges. It shows the organization's investment in capital equipment. A non-current asset register is also part of the internal control system

The non-current asset register facilitates such control by:

- Enabling physical checks to be made to verify the existence of non-current assets
- Enabling accountants to calculate the profit or loss when the asset is eventually disposed of, providing detailed records of the individual non-current asset
- Providing a record for checking the accuracy of the non-current asset records in the accounting system

Data recorded in a non-current asset register

There are no rules about the details to record in a non-current asset register, but a register may include the following for each non-current asset.

- An internal reference number for the asset (for physical identification purposes)
- The manufacturer's serial number for the asset (for maintenance purposes)
- Description of the asset
- Physical location of the asset
- Department that 'owns' the asset
- Purchase date (for calculation of depreciation)
- Cost
- Depreciation method applied to the asset and estimated useful life (for calculation of depreciation)
- Accumulated depreciation
- Disposal proceeds when the non-current asset is eventually sold off or scrapped, and the profit or loss on disposal

Recording events in the non-current asset register

The main events giving rise to entries in a non-current asset register, or 'inputs' in the case of a computerized one, would be the following.

- Purchase of an asset
- Sale of an asset or scrapping the asset
- Loss or destruction of an asset
- Transfer of an asset between departments
- Revision of estimated useful life of an asset
- Impairment of an asset, so that its carrying value in the accounts is reduced
- Revaluation of an asset, so that its carrying value in the accounts is increased

Format of non-current asset register

A non-current asset register may be a manual record or a computer file. It is not part of the double-entry bookkeeping system, but details recorded in the register are used to make entries for non-current assets (acquisitions, disposals and depreciation charges) in the general ledger of the bookkeeping system

Date of purchase	Invoice number	Ref	Item	Cost	Accum'd dep'n b/d	Dep'n expense	Accum'd dep'n c/d	Date of disposal	Disposal proceeds	(Loss)/ gain	Code number	Location

Most non-current asset registers are computerized. Here is an extract from a non current asset register showing one asset as it might appear when the details are printed out

Asset code: 938		
A	Description	Seisha Laser printer YCA40809 office publisher
B	Date of purchase	25.5.X4
C	Cost	Rs. 100,000
D	Accumulated depreciation	Rs. 30,000
E	Depreciation %	15%
F	Depreciation method	Straight line
G	Date of disposal	NOT SET
H	Sale proceeds	0.00
I	Accumulated depreciation account	55Q O/EQPT DEP CHARGE
J	Depreciation expense account	34F DEPN O/EQPT
K	Depreciation period	Standard
L	Comments	Electronic office
M	Residual value	0.00
N	Location	Office C12
O	Code number	01635

The identification number or asset code is the organization's internal reference number and will refer to the type of asset, possibly signifying the category and sub-category and possibly even the location

Components of a fixed asset

Some fixed assets that may be considered a single asset by its user may be recorded as several different assets in the non-current asset register. For example, a building consists of the land it is built on, the building structure, elevators, air conditioning unit and so on. These components of the fixed asset must be recorded as separate fixed assets because different depreciation rates apply to them

Removing assets from the non-current asset register and accounting general ledger

Assets should be removed from the non-current asset register and the accounting records when they are disposed of by sale or scrapped at the end of their useful life.

When existing assets are replaced, the new asset should be entered in the non current asset register, and the 'old' asset deleted. For example, when the existing elevators in a building are replaced, the old elevators should be removed from the non-current asset register, and the disposal should be recorded in the accounting system (often giving rise to a gain or loss on disposal)

B.5.6. Physical controls over non-current assets

There should be physical controls over non-current assets, to protect them against loss and damage

Non-current asset risk	Physical control
Buildings should be protected against damage or illegal entry.	Strong locks on doors, protection of windows against breakage, burglar alarms, fire alarms, security guards – are all possible methods of providing protection.
Machinery, equipment, elevators, heating systems, motor vehicles and other assets are all liable to break down.	Protection against the risk of breakdown should be provided by regular maintenance.
Small but valuable non-current assets, such as laptop or desktop computers, may be stolen if not properly protected.	These should be kept is a secure place, such as a locked desk drawer, when not being used. When employees take non-current assets such as laptop computers away from the office, they should be required to sign a document as evidence that they are in possession of the asset.

B.5.7. Disposal of non-current assets

Disposals of non-current assets should be authorized, particularly when they have a disposal value

Non-current assets may be disposed of, either at the end of their useful life or before the end of their useful life

Authorization of a disposal above a certain value should be recorded on a non current asset disposal form. An example is shown below. Note that the form contains a space to insert the reason for disposal. This reason will often be that the asset has become obsolete or worn out

ASSET DISPOSAL
AUTHORISATION FORM

Company/Division .....
Description and location of asset .....
.....
.....
Date of purchase .....
Date of disposal .....
Original cost .....
.....
Accumulated depreciation .....
Net book value .....
Sale/scrap proceeds .....
Profit/loss to statement of profit or loss .....
Reason for disposal .....
.....
.....
Authorised by: .....
Counter-authorised (if original cost over Rs. 100,000) by: .....

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B.5.8. Controls over non-current assets

Controls include controls over the purchase or disposal of non-current assets, through the CAPEX budget and authorization procedures, and also through a tendering process for major purchases; a requirement for financial justification for discretionary purchases/capital investments; physical controls over non-current assets; and controls using the non-current asset register

There should be controls over non-current assets. The following controls should be applied.

- ❑ Controls over the purchase or disposal of non-current assets, through the CAPEX budget and authorization procedures, and also through a tendering process for major purchases
- ❑ A requirement for financial justification for discretionary purchases/capital investments
- ❑ Physical controls over non-current assets
- ❑ Controls using the non-current asset register

Checks on the existence of fixed assets: physical identification of assets

There should be occasional checks to ensure that assets recorded in the fixed asset register do actually exist. These checks involve matching the recorded assets in the register with the physical asset.

- There may possibly be some assets that are held which have not been recorded in the register.
- More likely, there may be records in the fixed asset register where the physical asset cannot be found

There are different ways of physical identification of fixed assets.

(a) A manual sticker may be pasted to each fixed asset, containing the asset's unique identification number. Manual stickers are cheap to produce and use but reading the information on stickers and recording their identification number (in a reconciliation of physical assets with fixed asset register records) can be a slow process.

(b) A barcode label may be attached to each fixed asset, containing data that identifies the individual asset, including its unique identification number. Barcode labels are also cheap to produce. Their advantage over manual sticker labels is that the information on a barcode can be read automatically by a barcode reader. This speeds up the process of checking fixed assets, and reduces the risk of manual error in the check.

(c) Assets may also be identified using radio-frequency identification (RFID) tags. The information in tags can be read by an RFID reader. RFID tags are more expensive than barcodes, but the cost has reduced substantially in recent years

B.5.9. Business risks associated with the PPE management process

The main business risks associated with the PPE management process are those relating to:

- Acquisition of non-current assets without proper authorization or in excess of the organization’s ability to finance. Controls are provided by the CAPEX budgeting process and authorization rules
- Disposal of non-current assets without proper authorization
- Theft, loss or damage: these risks are reduced by physical controls. Losses due to theft may be identified by physical checks
- The risk that non-current assets cannot be found or do not exist. Physical checks using the non-current asset register will detect discrepancies
- The risk that the accounting records for non-current assets are incorrect: discrepancies can be detected by means of a reconciliation of the non-current asset register to the non-current assets accounts in the general ledger

Chapter review questions

1. Limits on capital expenditure are imposed by a _____ _____

2. Is the following statement true or false?
   In a tender process for the supply of a large capital item, the successful bidder may not be the one who quotes the lowest price
   True
   False

3. Which is the correct ending to the following statement?
   When a capital asset is purchased, details of the asset are recorded:

   A. First in the appropriate non-current asset account in the general ledger, and then in the non-current assets register
   B. First in the non-current assets register and then in the appropriate non-current asset account in the general ledger

4. What check can be made on the existence of assets recorded in the non-current asset register?

5. Non-current assets are given a unique identity in the non-current asset register by means of a _____ _____

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