Chapter 14

Auditing the Financing/Investing Process: Prepaid Expenses, Intangible Assets, and Property, Plant, and Equipment
Auditing Prepaid Expenses

*Other assets* that provide economic benefit for less than a year are classified as current assets.

*Prepaid expenses* are a common other asset. Examples include:
1. Prepaid insurance.
2. Prepaid rent.
3. Prepaid interest.
Substantive Procedures – Prepaid Insurance

Tests of Details of the Prepaid Insurance Account

Audit testing begins by obtaining a detailed schedule of the prepaid insurance account.

Existence and Completeness
Confirm policy with insurance broker, examine supporting source documents.

Rights and Obligations
Confirm policy beneficiary with the insurance broker.

Valuation
Determine unexpired portion of policy and insurance expense.

Classification
Determine propriety of distribution between manufacturing overhead and SG&A expense.
Auditing Intangible Assets

**Intangible assets** are assets that provide economic benefit for longer than a year, but lack physical substance. The following list includes examples of five general categories of intangible assets:

1. **Marketing** – trademark, brand name, and Internet domain names.
2. **Customer** – customer lists, order backlogs, and customer relationships.
3. **Artistic** – items protected by copyright.
4. **Contract** – licenses, franchises, and broadcast rights.
5. **Technology** – patented and unpatented technology.
Tests of Details of Intangible Assets

Tests of details associated with valuation and impairment of intangible assets are often necessary because the complexity and degree of judgment increase the risk of material misstatement.

Some substantive evidence is required for all significant accounts, and, as noted above, substantive analytical procedures are not likely to provide sufficient, appropriate evidence for significant transactions involving intangible assets.

Four assertions are normally considered for tests of details of intangible assets:

1. Existence and completeness.
2. Valuation.
3. Rights and obligations.
4. Classification.
Auditing the Property Management Process

Property, plant, and equipment usually represents a material amount in the financial statements.

Recurring Engagement
The auditor is able to focus on additions and retirements in the current period because amounts from prior periods have been subject to audit procedures.

New Engagement
The auditor has to verify the assets that make up the beginning balance in property, plant, and equipment.
Property Management Process at EarthWear Clothiers

Physical Plant

- Specialized PP&E transactions
- Review for proper recording
- Reconcile to general ledger

IT Department

- From purchasing process
  - PP&E transaction file
- Input
  - PP&E program
    - PP&E transaction report
    - PP&E subledger
  - Monthly
- General ledger master file
- General ledger program
- General ledger report

Reconcile to general ledger
Inherent Risk Assessment – Property Management Process

There are three inherent risk factors that must be considered by the auditor.

- Complex accounting issues.
- Difficult-to-audit transactions.
- Misstatements detected in prior audits.
Occurrence and Authorization

Control procedures for the occurrence and authorization of property, plant, and equipment are normally part of the purchasing process.

However, large capital asset transactions may be subject to additional controls.

Companies should have an authorization table for approving capital asset transactions.

Assets no longer in use.
The detailed property, plant, and equipment subsidiary ledger usually includes the following information for each capital asset:

1. **Description, location, and ID number.**
2. **Date of acquisition and installed cost.**
3. **Depreciation methods for book and tax purposes, salvage value, and estimated useful life.**
# Control Risk Assessment – Property Management Process

## Key Segregation of Duties and Possible Errors

<table>
<thead>
<tr>
<th>The function of initiating the purchase of a capital asset acquisition should be segregated from the final approval function.</th>
<th>If one individual is responsible for initiating a capital asset transaction and also has final approval, fictitious or unauthorized purchases of assets can occur. This can result in purchases of unnecessary assets, assets that do not meet the company's quality control standards, or illegal payments to suppliers or contractors.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The PP&amp;E records function should be segregated from the general ledger function.</td>
<td>If one individual is responsible for the PP&amp;E records and also for the general ledger functions, that individual can conceal any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account.</td>
</tr>
<tr>
<td>The PP&amp;E records function should be segregated from the custodial or safeguarding function.</td>
<td>If one individual is responsible for the PP&amp;E records and also has custodial responsibility for the related assets, tools and equipment can be stolen, and the theft can be concealed by adjustment of the accounting records.</td>
</tr>
<tr>
<td>If a periodic physical inventory of PP&amp;E is taken, the individual responsible for the inventory should be independent of the custodial and record-keeping functions.</td>
<td>If the individual who is responsible for the periodic physical inventory of PP&amp;E is also responsible for the custodial and record-keeping functions, theft of the entity's capital assets can be concealed.</td>
</tr>
</tbody>
</table>
Substantive Analytical Procedures – Property, Plant, and Equipment

The following substantive *analytical procedures* can be used in the audit of PP&E:

2. Compute the ratio of depreciation expense to the related PP&E accounts and compare to prior years’ ratios.
3. Compute the ratio of repairs and maintenance expense to the related PP&E accounts and compare to prior years’ ratios.
4. Compute the ratio of insurance expense to related PP&E accounts and compare to prior years’ ratios.
5. Review capital budgets and compare the amounts spent with amounts budgeted.
Tests of Details of Transactions and Account Balances and Disclosures

Completeness and Accuracy

Cutoff

Classification

Existence

Rights and Obligations

Valuation and Allocation

Disclosure Issues
Evaluating the Audit Findings
Property, Plant, and Equipment

The auditor aggregates the likely misstatements and compares this amount to the tolerable misstatement.

If the likely misstatement is less than the tolerable misstatement, the evidence indicates that the PP&E accounts are not materially misstated.

If the likely misstatement is greater than the tolerable misstatement, the auditor would either require adjustment of the accounts or issue a qualified audit report.
End of Chapter 14