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GUIDANCE NOTE ON AUDIT OF FIXED ASSETS*

Contents

* Issued in April, 1985.

The following is the text of the Guidance Note on Audit of Fixed Assets issued by the Auditing Practices Committee[1] of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices" issued by the Institute.

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices. (SAPs)[2] so that these may be issued by the Council of the Institute." Para.2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. Chapter 3 of the existing "Statement on Auditing Practices" related to "Fixed Assets" provides guidance in respect of both accounting and auditing aspects of fixed assets. The accounting aspects of fixed assets form the subject matter of an Accounting Standard on "Accounting for Fixed Assets" which is being prepared by the Accounting Standards Board of the Institute of Chartered Accountants of India. This Guidance Note on Audit of Fixed Assets therefore supersedes auditing aspects of the said Chapter 3 of the existing Statement.

3. This Guidance Note, however, does not supersede the Institute's publications which provide guidance on audit of fixed assets with special reference to certain statutes, e.g., the Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975.

4. In the event of a possible or perceived contradiction between the Guidance Note and a Statement on Standard Auditing Practices (SAP) issued by the Institute, the practices laid down in the SAP will prevail.

Introduction

5. Fixed assets are assets held for the purpose of providing or producing goods or services and are not meant for sale in the normal course of business. Therefore, an asset can be classified as a fixed asset or otherwise, depending upon the use to which it is put or intended to be put. For example, assets which are classified as fixed assets in one type of business may be

[1] Now known as Auditing and Assurance Standards Board (AASB).

[2] Now known as Auditing and Assurance Standards (AASs).

considered as current assets in another. Similarly, the same asset may be classified differently in an enterprise at different points of time.

6. Fixed assets normally constitute a significant portion of the total assets, particularly in a manufacturing enterprise. Audit of fixed assets, therefore, assumes considerable importance.

7. The following features of fixed assets have an impact on the related audit procedures:

(i) By their very nature, fixed assets are turned over much slower than current assets. Normally, fixed assets are carried over from year to year.

(ii) The average unit of fixed assets is normally of a relatively larger rupee value.

(iii) Since fixed assets are high value items, their acquisition is more effectively controlled. The control aspect assumes special significance where fixed assets are self-constructed.

(iv) In an inflationary situation, normally, the book values of fixed assets are considerably lower than their replacement values.

Internal Controls

8. An auditor should review the system of internal controls relating to fixed assets, particularly the following:

(i) *Control over expenditure incurred on fixed assets acquired or self-constructed*--an effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorisation of the expenditure incurred, also shows, in general, how effectively such expenditure is being controlled through periodical comparisons of actuals with budgeted figures.

(ii) *Accountability and utilisation controls*-accountability over each fixed asset (or each class of fixed assets) is established, among other things, by maintaining, appropriate records. This facilitates control aspects of custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of fixed assets. On the other hand, utilisation controls ensure that the individual fixed assets have been properly used for meeting the objectives of the enterprise.

(iii) *Information controls*-these controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims controlling repairs and maintenance charges etc.

Verification

9. Verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of fixed assets is primarily the responsibility of the management.

Verification of Records

10. The opening balances of the existing fixed assets should be verified from records such as the schedule of fixed assets, ledger or register balances.

11. Acquisition of new fixed assets and improvements in the existing ones should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds.

12. Self-constructed fixed assets, improvements and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work-order records and independent confirmation of the work performed.

13. The auditor should scrutinise expense accounts (e.g. Repairs and Renewals) to ascertain that new capital assets and improvements have not been included therein.

14. Where fixed assets have been written-off or fully depreciated in the year of acquisition/construction, the auditor should examine whether these were recorded in the fixed assets register before being written-off or depreciated.

15. In respect of fixed assets retired, i.e., destroyed, scrapped or sold, the auditor should examine (a) whether the retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed wherever applicable; (b) whether the assets and depreciation accounts have been properly adjusted; (c) whether the sale proceeds, if any, have been fully accounted for; and (d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the Profit and Loss Account.

16. It is possible that certain assets destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

(i) Review work orders/physical verification reports to trace any indicated retirements.

(ii) Examine major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired.

(iii) Make enquiries of key management and supervisory personnel.

(iv) Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

17. The ownership of assets, like land and buildings should be verified by examining title deeds. In case, the title deeds are held by other persons, such as solicitors or bankers, confirmation should be obtained directly by the auditors through a request signed by the client.

Physical Verification

18. It is the responsibility of the management to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by observing the verification being conducted by the management wherever possible and by examining the written instructions issued to the staff by the management and the relevant working papers. The auditor should also satisfy himself that the persons conducting the verification, whether the employees of the enterprise or outside experts (if employed), had the necessary competence.

19. The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very

fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land. Where the fixed assets can be moved and where verification of all assets cannot be conducted at the same time, they should be marked with distinctive numbers.

20. The auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered as reasonable. However, where the assets are numerous and difficult to verify, a verification, say, once every three years by rotation - so that all assets are verified at least once in every three years – may be sufficient.

21. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with. In this regard the auditor has to use his judgement as to whether having regard to the circumstances, the discrepancy is material enough to warrant an adjustment in the accounts and/or modification in the internal control system.

Valuation and Disclosure

22. The auditor should satisfy himself that the fixed assets have been valued and disclosed in the financial statements according to the generally accepted bases of accounting which are determined by law, professional pronouncements[3] and prevailing practices.

23. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted bases of accounting for depreciation.

24. Revaluation of fixed assets implies restatement of their book values on the basis of systematic scientific appraisal which would include

[3] An illustrative list of professional pronouncements on the subject is given in Appendix A.

ascertainment of working condition of each unit of fixed assets, technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

25. Where several assets have been purchased for a consolidated price, the auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and based on adequate facts.

26. Where an enterprise owns assets jointly with others (otherwise than as a partner in a firm) the auditor should examine the relevant documents such as title deeds, agreements etc., in order to ascertain the extent of the enterprise's share in such assets.

Appendix

List of publications issued by the Institute of Chartered Accountants of India, which indicate the generally accepted bases of accounting of fixed assets.

A. Accounting Standards

1. Disclosure of Accounting Policies (AS 1).
2. Prior Period and Extraordinary Items and Changes in Accounting Policies (AS 5)[4].
3. Depreciation Accounting (AS 6).
4. Accounting for Fixed Assets (AS 10).

B. Other Publications

1. Guidance Note on Treatment of Expenditure During Construction Period.
2. Statement on Accounting for Foreign Currency Translation[5].
3. Guidance Note on Accounting Treatment of Interest on Deferred Payments.
4. Guidance Note on Accounting for Capital Based Grants[6].
5. Guidance Note on Treatment of Reserves Created on Revaluation of Fixed Assets.
6. Guidance Notes on Provision for Depreciation
7. Guidance Note on Mode of Valuation of Fixed Assets.

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[4] The Accounting Standard was revised in 1997. The revised Accounting Standard is AS 5, Net Profit a Loss for the Period, Prior Period Items and Changes in Accounting Policies.

[5] This Statement has been withdrawn pursuant to issuance of Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates.

[6] This Guidance Note has been withdrawn