

"... get a handle on your assets."

WHAT DEFINES A MATERIAL BREACH OF FIXED ASSET ACCOUNTING AS IT RELATES TO SARBANES-OXLEY COMPLIANCE REQUIREMENTS?

Asset Management Resources, a division of TEKsystems, Inc.

Sarbanes-Oxley has overwhelmed organizations financially as well as imposing a significant demand on human resources. Initially the compliance burden has focused on financial areas such as cash, revenue recognition, and stockholder equity. Compliance requires documenting the "internal controls" and "business processes" used within an organization for any financial matter considered material. After identification of a material item, the issue is evaluated to determine if it constitutes a material weakness. If the internal controls are properly defined and enforced, it is expected that the checks and balances will ensure accurate financial reporting.

Consequently, what is considered material within an organization; i.e., what level of materiality would concern an investor and give cause for further evaluation? According to the AICPA:

"MATERIALITY IS BASED ON THE ASSUMPTION a reasonable investor would not be influenced in investment decisions by a fluctuation in net income less than or equal to 5%. This "5% rule" remains the fundamental basis for working materiality estimates." [The New Importance of Materiality: AICPA](#)

This 5% rule is one of the quantitative tests performed by auditors to identify potential areas of materiality that may require further evaluation. If an area is identified, it prompts the need for further qualitative analysis.

Up until now a quantitative measure has not been available specifically for fixed assets. However, AMR has accumulated actual statistics from the past sixteen years of client engagements and has documented that the average unrecorded disposals are 1.5% of the Net Book Value of Property, Plant and Equipment. Thus, applying the 5% rule, if the value of the fixed asset calculation is greater than the 5% EBITA value, a materiality issue may exist. The formula can be expressed as follows:

1.5 percent times the Net Book Value of Property, Plant and Equipment
5 percent of stabilized earning before interest, taxes and allowances (EBITA)

After performing this calculation, if the ratio is greater than one (1), fixed assets is a **material consideration**. This alone does not constitute a material weakness, but it does suggest that a qualitative evaluation is warranted. This is the first step in determining if a material weakness may exist.

The qualitative analysis evaluates whether the internal controls and business processes are sound enough to ensure a material weakness does not exist. If the fixed asset materiality ratio was greater than one (1) the relevance of this ratio takes into consideration several qualitative possibilities:

1. A high property value due to large holdings of real estate, common in retail chains and banks.
2. A highly capital intensive industry with extensive investment in machinery and equipment.
3. Unrecorded disposals overstating the fixed asset balance.
4. And many others.

It should be noted that a material weakness may still exist even after the qualitative analysis concludes that past practices and/or newly defined controls are not deficient. One must answer the following:

Are internal controls and defined business processes sufficient to ensure the published financial reports are accurate?

Are past business practices immune from further scrutiny after new procedures are put into place?

Has sufficient attention been given to the corporate fixed assets since they are a substantial portion of the balance sheet?

These are important questions.

A prudent auditor would undoubtedly pursue answers to these questions and determine whether a material weakness may still exist. **This verification process comes at a cost** whether it is done with internal or external resources. This usually entails extensive interviews, process flow diagrams, validating documentation, following the process to ensure proper implementation, and sufficient separation of duties to provide necessary checks and balances.

But what if the quality of the data in the supporting financial systems is simply poor?

Do the fixed asset financial records reflect what actually exists?

Are there unrecorded disposals or additions?

For fixed assets, the only definitive method to validate the quality of data in the system is a physical inventory. An organization can institute documented business processes for fixed asset management that meet or exceed Sarbanes-Oxley requirements, but until an accurate baseline is established there may still be a material weakness. Validation of fixed assets is the only definitive method to ensure that the improved business processes and internal controls will deliver on the promise of accurate financial reporting.

Compare the cost and benefit of a baseline physical inventory versus an evaluation of internal controls; determine which gets the organization closer to Sarbanes-Oxley compliance.

It is possible that an evaluation of internal controls will meet Sarbanes-Oxley compliance requirements, but it does not mend bad legacy data from previous reporting periods. In short, evaluating and instituting process improvements of internal controls alone does not ensure a material weakness has been repaired. Conducting a baseline physical inventory and instituting improved business processes, if needed, more effectively accomplishes the quantitative and qualitative requirements to meet Sarbanes-Oxley compliance.

We invite you to visit other interesting links on Sarbanes-Oxley:

[Materiality Defined](#) - AICPA

[How a Material Weakness Can Cost You](#) - CFO.com

[Uncorrected Material Weakness and its Aftermath](#) - US Army

[Correcting a Significant Deficiency or Material Weakness](#) - BDO Financial Reporting

[Ensure Sarbanes-Oxley Compliance and the Balance Sheet](#) - Sunflower Systems

[Financial Statement Audit Management Recommendations](#) - Metro Office of the Auditor

[Data Validation to Compliance - Asset Management Resources](#)

Asset Management Resources (AMR) has inventoried millions of fixed assets with an accumulated Gross Book Value in excess of \$150 billion dollars. Our expertise encompasses the project management and technological competencies to collect information within a corporate operating environment with limited disruption and maximum efficiency. The process incorporates a variety of quality control mechanisms to ensure completeness, accuracy, and uniformity of data. Furthermore, AMR's Consulting Services can help clients institute improved business processes to take advantage of the accurate baseline. There is no reason to shake the confidence of shareholders by reporting a material weakness when cost effective methods are available to meet Sarbanes-Oxley requirements.

For additional information about AMR's Fixed Asset Inventory and Reconciliation services please contact:

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