UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT
PURCHASE CAPITAL GOODS

Control practices

The following control objectives provide a basis for strengthening your control environment for the process of purchasing capital goods. When you select an objective, you will access a list of the associated business risks and control practices. That information can serve as a checklist when you begin reviewing the strength of your current process controls.

This business risk and control information can help you assess your internal control environment and assist with the design and implementation of internal controls. Please note that this information is at the generic business process level and many companies will need to go beyond generic models to address the specific business processes that support the financial and nonfinancial disclosures being made. You can combine the insight of this business risk and control information with your industry-specific knowledge and understanding of your company's environment when conducting internal control assessments and designing and implementing recommendations.

Effectiveness and efficiency of operations

A. Fixed assets are safeguarded.
B. Capital goods are acquired on a timely basis.
C. Capital goods acquired are cost-effective.
D. Cost overruns and non-budgeted costs are controlled.
E. Installations of capital goods are performed correctly.
F. Employees and management are provided the information they need to control the capital expenditure process.
G. Property acquisitions and dispositions are properly authorized.
H. Fixed asset transactions are completely and accurately recorded on a timely basis.
I. Fixed asset transactions are reliably processed and reported.
J. Recorded balances are substantiated.
K. Recorded balances are evaluated.
L. Performance measures used to control and improve the process are reliable.

Compliance with applicable laws and regulations

A. The process of acquiring capital goods complies with applicable laws and regulations.

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Effectiveness and efficiency of operations

A. Fixed assets are safeguarded.

Business risks

- The company will not maintain adequate physical security over fixed assets; therefore, fixed assets will be susceptible to risk of loss, theft, or damage.
- The company's records will be stolen, lost, destroyed, or altered, resulting in 1. The inability to prepare financial records, or 2. Concealment of asset misappropriations.

Control practices

1. Establish and communicate policies and procedures to safeguard fixed assets.
2. Establish physical security measures for company facilities and limit physical access to authorized personnel only. Include such measures as security guards, receptionists, identification badges, security inspections, and alarm systems.
3. Inspect, identify, and document all physical items issued and fixed asset movements.
4. Review insurance coverage periodically.

B. Capital goods are acquired on a timely basis.

Business risks

- Lack of timely acquisitions will result in delays in planned production increases.
- Lack of timely acquisitions will result in delays in the introduction of new products.
- Delays in acquisitions will result in additional costs such as costs of acquiring temporary resources and overtime costs for extra production on existing machinery.

Control practices

1. Develop a long-range planning and capital budgeting system to identify long-term requirements and allow for sufficient lead time to acquire capital goods on a timely basis.
2. Develop a long-term supply plan with the vendor for capital goods that have a regular requirement or replacement program.
3. Monitor the timeliness of capital goods availability.
4. Analyze the reasons for late delivery and installation and use this information to improve the capital acquisition process.

C. Capital goods acquired are cost-effective.

Business risks

- The company will acquire capital goods that do not provide the highest return on investment.
- The company will acquire capital goods that do not meet quality standards.

Control practices

1. Identify the basic criteria for required capital goods and determine possible supply sources before acquiring them.
2. Obtain quotes from suppliers and select the lowest quote for generic goods.
3. Consider quality, cost, and specific supplier capabilities when acquiring non-generic goods.
4. Document the process for evaluating capital goods purchasing.
5. Define selection criteria for capital goods by a combination of cost, quality, service, delivery time, capacity, life expectancy, and technology.
6. Eliminate vendors whose products will not meet the base criteria for capital goods (for example, if they are too costly, have insufficient capacity, or require a long delivery lead-time).
7. Rank suppliers on returns-on-investment (ROI) or other cost-based criteria, where product capabilities are similar. Analyze ROIs based on factors such as cost, estimated life, typical maintenance costs, capacity, and sales expectations.
8. Select suppliers based on cost ranking in relation to other performance criteria, such as desired quality standards.
9. Review the adequacy of the capital goods evaluation process periodically by comparing the actual performance of fixed assets and achieved ROIs with those calculated during the planning process.
10. Determine the reasons for variations and make necessary adjustments to the evaluation process.

D. Cost overruns and non-budgeted costs are controlled.

Business risks

- Non-budgeted costs will reduce profitability.
- The company will be forced to reduce planned acquisitions to remain within budget.

Control practices

1. Negotiate fixed price contracts with suppliers or project managers for the purchase and installation of major capital goods.
2. Appoint an experienced member of management as project manager with full responsibility for overseeing the project and controlling project costs.
3. Develop procedures for handling questions concerning additional and unexpected costs.
4. Develop procedures for handling guarantees for fixed price contracts for certain parts of the project.
5. Develop procedures for approving orders for changes.
6. Develop procedures for handling disputes regarding unbudgeted costs.

E. Installations of capital goods are performed correctly.

Business risks

- Incorrect installations will result in additional maintenance costs.
- Poor installations will result in reductions in the useful lives of fixed assets.

Control practices

1. Require that either the vendor or other suitably qualified experts install capital goods.
2. Obtain relevant guarantees or warranties concerning the installation of capital goods.
3. Use performance measures to monitor the capital goods installation process.
4. Monitor additional maintenance or equipment problems due to faulty capital goods installation.
5. Analyze the reasons for equipment failures and use the results to improve the capital goods installation process.

F. Employees and management are provided the information they need to control the capital expenditure process.

Business risks

- Information provided to employees and management about the capital expenditure process will conflict with company objectives.
- Employees will not improve the capital expenditure process on a timely basis.
- Employees and management will not accurately determine whether the capital expenditure process is operating properly.
- Plans to improve the capital expenditure process will be based on incorrect perceptions about process performance.

Control practices

1. Identify and understand customer expectations.
2. Identify and understand the company's goals in relation to improving quality, reducing cost, and compressing cycle time.
3. Ensure selected performance measures are quantifiable and controllable and use them to link process performance to company goals and customer expectations as well as to stimulate continuous improvement.
4. Determine what key data needs to be collected and how it is to be measured in order to produce the selected performance measures.
5. Educate managers on how the process contributes to customer satisfaction and how company objectives drive all performance measures.

G. Property acquisitions and dispositions are properly authorized.

Business risks

- The company will make unintentional or intentional disbursements of cash to unauthorized parties.
- Illegal or improper arrangements between vendors and company representatives will lead to undetected sensitive payments and purchases at higher than normal prices.
- Unnecessary purchases will lead to write-downs or write-offs of unusable or unsalable items.
- Expensing capital expenditures will cause understatements of fixed assets.
- Incorrect estimates of useful lives will cause unreasonable depreciation or amortization periods.
- The company will not adequately consider the income tax ramifications associated with estimated useful lives.
- Asset disposals or transfers will not be communicated to proper personnel.

Control practices

1. Require management to approve the criteria for determining the prices, timing, and terms of capital acquisitions.
2. Require formal written requests and authorizations by the board of directors and/or by designated officials for 1. Additions over a specified amount, and 2. Expenditures on property in excess of amounts originally authorized (cost overruns).
3. Compare the costs of assets to be purchased with average costs of similar assets.
4. Require management approval for the capitalization and expensing policy.
5. Require management approval for the depreciation and amortization policy used for newly acquired fixed assets.
6. Review the estimated useful lives of fixed assets periodically for continued appropriateness.
7. Review depreciation details for accuracy and compliance with policies and procedures.
8. Ensure the tax department reviews the depreciable lives used for tax purposes.
9. Install computer system controls, such as access control software, to preclude unauthorized initiation of fixed asset transactions.
10. Require management approval of any sale or disposal of fixed assets.

H. Fixed asset transactions are completely and accurately recorded on a timely basis.

Business risks

- Errors will be made in posting transactions to the fixed asset subsidiary ledger, including incomplete, inaccurate, or misclassified postings.
- Insufficient records will preclude substantiation of account balances.

Control practices

1. Establish clear definitions for asset categories.
2. Ask purchasing or other personnel to clarify asset description or function.
3. Use pre-numbered and controlled authorization forms for property acquisitions and disposals.
4. Implement controls such as batch tools and ensure appropriate accounting personnel have accounted for and reconciled all fixed asset transactions entered and processed by the system.
5. Investigate purchase orders for capitals goods not matched with receiving documentation after anticipated receipt date.
6. Gather relevant process information using customer surveys and other sources of information, such as percentage of on-time deliveries.
7. Design the computer system to produce reports that highlight high dollar fixed asset transactions for all significant assets on a timely basis.
8. Design the computer system to produce depreciation schedules for all significant assets on a timely basis.

I. Fixed asset transactions are reliably processed and reported.

Business risks

- Unauthorized changes will be made to programs, causing unauthorized processing results.
- Unauthorized versions of either files and/or programs will be used in processing, resulting in unauthorized or incorrect business transactions.

Control practices

1. Require proper authorization of all changes to program routines.
2. Require user approval of program test results.
3. Employ tape and/or disk management systems to ensure that appropriate versions of transaction files, master files, and programs are used in processing.
4. Install computer system security controls to preclude unauthorized changes in the version of the files and programs used to process transactions.

J. Recorded balances are substantiated.

Business risks

- Employees will make unauthorized acquisitions and disposals of fixed assets that remain undetected.
- Errors in the processing, summarizing, and recording of acquisitions and disposals of fixed assets will occur.

Control practices

1. Use the accounting system to generate periodic comparison reports on actual depreciation versus budgeted amounts, prior period amounts, and industry statistics.
2. Maintain subsidiary records for each category of fixed assets. Provide sufficient details to adequately identify and describe each asset, identify its location and reference number, state its cost and accumulated depreciation, and provide the necessary tax information.
3. Reconcile fixed asset additions with capital expenditure authorizations.
4. Assign employees with no incompatible duties to physically count fixed assets periodically and verify titles to substantiate recorded amounts.
5. Assign employees with no incompatible duties to reconcile periodically the general ledger balances with the detailed property records. Or, configure the application(s) used to perform this function automatically.
6. Confirm property in the custody of third parties and property leased or borrowed from third parties during the periodic physical counts.
7. Adjust the physical asset records and control accounts periodically for differences disclosed by the physical counts, reconciliations, and confirmations.
8. Affix asset identification tags promptly to acquired fixed assets, except when deemed inappropriate.
9. Document key related process activities.

K. Recorded balances are evaluated.

Business risks

- Recorded balances will not reflect realistic evaluations under conditions existing at a particular date.

Control practices

1. Program the accounting system to generate periodic comparison reports on actual depreciation versus budgeted amounts, prior period amounts, and industry statistics.
2. Review the fixed assets used for discontinued and new products and product lines.
3. Inspect the physical condition of fixed assets periodically.
4. Evaluate the economic lives of property periodically.
5. Require management authorization of any adjustments to fixed asset values and lives.
6. Report any significant accumulations of idle or surplus fixed assets to management.
7. Document key activities of this process.

L. Performance measures used to control and improve the process are reliable.

Business risks

- Inaccurate measures will result in erroneous perceptions about process performance, resulting in inappropriate decisions.

Control practices

1. Compile and process measurements based on data captured at the transaction source.
2. Review performance measures periodically to ensure they reflect process performance.
3. Obtain relevant information about the capital expenditure process via management and user feedback.
4. Obtain relevant information about the capital expenditure process via management and user feedback, and communicate the information to employees responsible for improving the capital expenditure process.

Compliance with applicable laws and regulations

A. The process of acquiring capital goods complies with applicable laws and regulations.

Business risks

- The company will incur fines or other penalties.
- Noncompliance with laws and regulations will delay acquisition of necessary goods.
- Cost and accumulated depreciation information required for tax purposes will not be available.

Control practices

1. Involve the legal department in reviewing acquisitions for compliance with all relevant laws and regulations.
2. Involve the legal department in developing acquisition procedures to ensure compliance.
3. Involve the legal department in obtaining any necessary permits or licenses.
4. Appoint a designated legal officer to guide management about compliance with laws and regulations.