Performance Audit

Non-Real Estate Capital Asset Management

Durham County Internal Audit Department

December 10, 2014

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December 10, 2014

Mr. Wendell Davis,
County Manager

Dear Mr. Davis:

The Internal Audit Department has completed its audit of the Finance Department's controls over and implementation of the capital assets management program. The audit focused on determining if sufficient internal controls exist to ensure that non-real estate property is (1) accurately valued, (2) safeguarded, and (3) disposed of appropriately.

We identified several issues during the audit. They included depreciation calculations, asset classification, and item identification tagging. This report includes several recommendations to address these issues. The Finance Department agreed with the report findings and have begun the process of implementing report recommendations. The Department's official response is attached as appendix I.

Melanie Burke, Senior Internal Auditor was the Auditor-In-Charge of this assignment. We thank the Finance Department staff for its cooperation during the audit engagement.

Sincerely,

Richard C. Edwards

Richard Edwards,
Internal Audit Director

CC: George Quick, Director of Finance
Audit Oversight Committee
BOCC

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INTRODUCTION

The Audit Oversight Committee approved this audit in the fiscal year 2015 Annual Audit Plan. The audit reviews controls over recording, valuation, safeguarding, and disposal of non-real estate capital assets and compliance with County capital asset policies.

We conducted this audit in accordance with generally accepted government auditing standards. The standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. I believe the evidence obtained provides a reasonable basis for the findings and conclusions based upon the audit objectives.

Performance audits are defined as audits that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.[1]

AUDIT OBJECTIVES

We conducted fieldwork for the audit engagement between September 2, 2014, and October 28, 2014. Specific questions to be answered were:

1. Are assets accurately valued?
2. Are assets appropriately safeguarded?
3. Are assets properly disposed of when they are no longer useful?

SCOPE AND METHODOLOGY

The scope of the audit included non-real estate capital assets on hand as of June 30, 2014. Not included in the scope of this audit were real estate related capital assets including land, easements, construction in process, buildings and building improvements, and sewer lines. Also excluded from the scope of this audit was computer software. Specific audit steps included:

1. Obtaining and reviewing copies of written policies and procedures for recording, reporting, safeguarding, and disposing of assets.
2. Interviewing Finance Department staff to gain an understanding of the department’s processes and procedures for recording, safeguarding, and disposing of assets.
3. Recalculating the book value of assets as of June 30, 2014, by dividing the item’s acquisition value by the useful life and comparing our results (the remaining value of the assets) to the remaining book value reported by the Finance Department.

[1] Comptroller General of the United States, *Government Auditing Standards,* Washington D.C.: U.S. Governmental Accountability Office, 2011, p.17.

4. Comparing the County's processes and procedures over the safeguarding of capital assets to best practices.
5. Reviewing capital asset disposal procedures and examining the most recent auction performed to determine if the County is following proper disposal procedures.

We judgmentally selected and reviewed 90 items or ten percent of the asset inventory (valued at approximately $4M) on hand as of June 30, 2014 to conduct the audit.

BACKGROUND

Methodology for managing non-real estate capital assets is set out in Policy No. PL97-0001. The policy, which was initially enacted in March 1997, was last revised in June 2010. According to the policy, a capital asset may be tangible and non-consumable or intangible. If the asset is tangible and non-consumable, the acquisition cost must be $5,000 or more. If it is intangible, the cost or fair market value must be $50,000 or more and have a useful life of at least three years. As of June 30, 2014, the book value of capital assets held by County was approximately $473 million.

The Finance Department in conjunction with user departments manage capital assets. The Finance Department is responsible for implementing the practices and procedures needed to record and account for capital assets. As such, the Department affixes identification tags (tags) on non-real estate assets (excluding computer software), maintains inventory documents including asset values, and physically verifies the capital asset records by conducting a physical inventory count on a staggered basis every two years. User department heads, as custodians, are responsible for the proper use, maintenance, and control of its assets. This custodial responsibility includes notifying the Finance Department of any changes in the status of an asset.

Capital assets are recorded in the SAP Enterprise Resource Planning System (SAP). Depreciation is automatically calculated by SAP based upon the assigned value and asset class and calculation formulas configured in the system.

Items no longer useful are disposed of by either being written off (e.g., junked because either not repairable, lost, stolen, etc.) or by being sold through public auction. Processes and procedures for disposal are set out in North Carolina General Statute 160A, Article 12. The statute allows for disposal by:

(1) Private negotiation and sale,
(2) Advertisement for sealed bids,
(3) Negotiated offer, advertisement, and upset bid,
(4) Public auction, and
(5) Exchange.

Durham County primarily uses public auction as its main method of disposal. According to a Finance Department representative, the County averages one to two auctions per year.

FINDINGS AND CONCLUSIONS

Audit results show that some areas of the capital assets management program need correction and enhanced controls. We found (1) six depreciation calculation errors, (2) two items identified under an incorrect asset class, and (3) thirty-one items that were not identified with appropriate inventory tags. Other important areas are operating according to policy and industry best practices. For example, surplus property disposal and procedures for safeguarding assets were operating appropriately for the items we reviewed. We located all items at the locations cited in inventory records.

Depreciation Was Not Calculated Correctly in the SAP Asset Management Module for Some Computer Hardware Assets

Computer hardware assets assigned a useful life of three years are being incorrectly depreciated over a period of 37 months instead of 36 months (or three years). We reviewed 11 of 57 computer hardware assets held by the County as of June 30, 2014, which were recorded as 36-month life cycle items. We found six items for which the depreciation was calculated incorrectly. Upon further investigation by the Finance Department, it's representatives found that all computer hardware items assigned a 36-month useful life were depreciated incorrectly in the manner we discovered. The amount of error in these calculations is approximately $57K. These errors did not occur in other 36-month computer assets such as computer software nor did it occur in any other asset classifications.

The above errors occurred because the configuration was not properly set within the SAP system for computer hardware assets. Once entered into the SAP system, asset depreciation and capitalization values are automatically maintained by the system based upon the configuration established in the specific SAP module for that asset class. Erroneous calculation results will continue until the configuration is revised/corrected for this asset class.

This report recommends that the Finance Department work with SAP Administrators in the Information Technology Department to correct the depreciation calculation issue. We also recommend that Finance Department representatives assure that erroneously depreciated values are corrected and correct values reported in financial documents.

Two Items Were Not Classified In the Correct Asset Class

We identified two items that were incorrectly classified resulting in an overstatement of $3,344. This amount is not substantial, however; it provides an opportunity to enhance controls over asset classification.

Classification of a new item determines its useful life for valuation purposes. Items are classified based upon its use and nature. For example, computer hardware and furniture are different in nature and use. Those items are subsequently classified differently resulting in different life expectancy for depreciation and valuation purposes. The facts surrounding the two incorrectly classified items follow:

> One item described as a "Network Based Records Management System", a computer server, falls under the "computer hardware" classification and has a useful life of 3 years. The item was incorrectly classified as "office furniture", which has a useful life of seven years. That item had been fully depreciated.
>
> One item described as a "Gator 4x4", a utility machine, falls in the "machinery and equipment" classification and has a useful life of 5 years. The item was incorrectly classified as "office furniture and equipment", which has a useful life of seven years. The item had a book value net of depreciation of approximately $3,344 as of June 30, 2014. If it had been assigned the proper asset class and depreciated properly, the item would have been fully depreciated as of June 30, 2014, showing a book value net of depreciation of $0.00.

A Finance Department representative told us the Finance Department Accountant in charge of capital assets is responsible for correctly classifying capital assets when they are purchased and entered into SAP. According to the representative, the person making the SAP entry will use the item description and other information from the purchase order to classify the asset. When assigning the asset class, the useful life is automatically assigned. The asset class and its corresponding useful life is configured in the SAP System.

We could not determine what caused the classification errors, however; we learned that one item was purchased before SAP was implemented. The County no longer employs the employee conducting the process at that time. A current employee entered the second item into the books in April 2009 but we could not determine the cause of that classification error. Because we only identified two misclassified items in our review of 90, and because both items had been booked at least five years ago, we believe the misclassification was an infrequent oversight.

We did not make a recommendation to correct the issue regarding misclassified assets because audit standards do not allow recommendations when causes cannot be determined.[2] However, Finance Department representatives said they have formalized procedures in place they believe to be effective and efficient. However, they stated that it would be good to reiterate these procedures by "reaching out and communicating to County Management and department heads, the Purchasing Division, the Compliance Manager, and the Accountant, to emphasize the process and stress the importance of complete and accurate descriptions for capital assets and assignment of corresponding correct asset classes." We agree with the solution and believe this will provide enhanced controls over the classification process. Although we could not make a recommendation to correct the misclassification issue, this report recommends that the Finance

[2] Audit standards require recommendations be tied to the "cause" of a condition to assure that the recommendation will be effective. The premise is that addressing the cause will facilitate regaining a condition more in line with "the intended condition" in lieu of an unintended, incorrect, or out-of-line condition.

Department adjust the value of the overstated item and transfer each asset to its correct class.

Identification Tags Affixed According to Current Policy and Processes but Need to Be More Timely

Affixing identification tags to assets were not conducted timely. Thirty-one of 90 items in our test sample did not have the acceptable descriptive tags to allow for positive identification. Sixteen items added to the inventory in fiscal years 2014 and 2013 had been in the inventory for up to two years without an identification tag. The classification and types of assets missing tags varied and included utility tractors and mowers, generators, computer servers, and printers. The items without tags had a book value of approximately $288,004 as of June 30, 2014. Best practices for capital assets state that identification tags reduce the risk of assets becoming stolen, lost, misplaced, or mishandled. County policy states that capital assets should be appropriately identified with tags in a conspicuous location to establish its identity and ownership. The Chief Financial Officer agrees that identification tags are a factor in providing added controls over inventory management. This report recommends that the Finance Department develop a process for affixing identification tags that include distribution of tags to department heads or their designee for attachment when items are received.

The items were not tagged because current procedure is to attach identification tags to items during the bi-annual inventory process. As a result, an asset could be on the books for up to two years before an identification tag is attached. In discussing this issue with Finance Department representatives, they agreed that "tagging" should be timelier. A department representative suggested that a solution is to distribute capital asset tags to department heads or their respective designee upon the item purchase so the department can attach the tags to the item at that time accordingly. The Finance Department representative said the Finance Department would verify that asset tags have been applied appropriately during the bi-annual capital asset inventory count.

Although untagged inventory had a relatively high value, they were secured and appropriately safeguarded. We found all the items in our sample at the locations reported by the Finance Department on its inventory list. In addition, all items were stored properly and protected as needed by locks, fences, or other secured locations as required. Items exposed to weather conditions were the usual types of items such as machinery and equipment usually found in such environments.

Asset Disposal Procedures Were Appropriate

The County disposes of capital assets once they are no longer useful. They are written-off or junked it not repairable, lost, or stolen, etc. When the item is functional but of no use, it is sold via public auction. We reviewed documentation for assets disposed of during the last public auction held by Durham County that took place on March 24-31, 2014. That auction, for the sale of 22 surplus vehicles, complied with the requirements of the state statute. In complying with the statute, the Finance Department (1) obtained approval from the Board of County Commissioners and (2) appropriately issued public notices including specifics of the sale such as time, date, and condition of the property.

In addition to complying with the statute regarding the sale, financial reporting processes are required as well. The Finance Department complied with its financial reporting requirements. Each item sold at auction was appropriately removed from the capital asset inventory listing as of June 30, 2014, the date of the sale. In addition, the proceeds of $55,347.10 from the sale were recorded appropriately.

RECOMMENDATIONS

To enhance controls regarding the report findings we made the following recommendations to the Finance Department:
To enhance controls regarding the report findings, we made the following recommendations to the Finance Department:

1. Work with the Information Technology Department and external consultant(s) to correct the depreciation calculation for computer hardware asset class with a three-year depreciable life.

2. Correct erroneously depreciated values for the computer hardware asset class and report them correctly.

3. Transfer both misclassified assets to the appropriate asset class in SAP and adjust the current book value of the 4x4 Gator capital asset to reflect being fully depreciated.

4. Develop a process for affixing identification tags that include distribution of tags to department heads or their designee for attachment when item is received.

Appendix 1: Official Comments

Finance

TO: Richard Edwards, Internal Auditor

FROM: George K. Quick, Chief Financial Officer GKQ

RE: Response to: Non-Real Estate Capital Asset Management Audit

DATE: December 3, 2014

This memo is intended to respond to the recommendations made in the Non-Real Estate Capital Asset Management Audit. The Finance Department has reviewed the Audit and agrees with the findings. Below we have responded to your recommendations.

1. Work with the Information Technology Department and external consultant(s) to correct the depreciation calculation for computer hardware asset class with three-year depreciable life.

   Finance response: Finance agrees with the recommendation. Finance has already communicated with staff in the SAP Shared Services Division of the Information Services and Technology Department (IS&T) on how to correct the configuration. The solution has been identified and will need to be successfully tested in the development (DEV) client and quality assurance (QA) client of SAP before we can move the correction to the production (PRD) client. It is Finance's intention to have this correction in the SAP Asset Management (AM) Module in production by the end of December 2014.

2. Correct erroneously depreciated values for the computer hardware asset class and report them correctly.

   Finance response: Finance agrees with the recommendation. The external consultant we spoke with regarding this issue told us that once the configuration is corrected in production, the next monthly depreciation process will correct the accumulated depreciation for this asset class in the current period. As such, when the December 2014 month-end process is completed, the SAP AM will show the correct accumulated depreciation for the computer hardware asset class accordingly.

3. Transfer both misclassified assets to the appropriate asset class in SAP and adjust the current book value of the 4x4 Gator capital asset to reflect being fully depreciated.

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Finance response: Finance agrees with the recommendation. Finance has transferred the two assets to their correct asset class. When the December 2014 month-end process is completed, the system will update the accumulated depreciation for the "Gator 4x4" to the correct amount posting to the current period. As such, SAP AM will reflect the asset being fully depreciated at the end of December 2014 accordingly. In addition, Finance will reach out and communicate to County management, department heads, the Purchasing Division, the Compliance Manager and the Accountant reiterating the formalized process and stressing the importance of complete and accurate descriptions for the capital assets being purchased and the assignment of the corresponding correct asset class in the process.

4. Develop a process for affixing identification tags that include distribution of tags to department heads or their designee for attachment when item is received.

   Finance response: Finance agrees with the recommendation. Finance has drafted a revision in the process whereby when an asset is purchased, the tag is assigned by the Accountant to the asset and distributed to the department head or their designee for attachment to the asset within a "required timeframe" after receipt of the asset and completion of the purchase. The revised process also requires confirmation of the attachment of the tag to the asset via email to the Accountant in Finance. The Accountant in Finance will ensure the tag has been affixed to the asset at the time of inventory. The new, revised process is attached with an effective date of December 1, 2014.