EQUIPMENT DISPOSITION ANALYSIS

A careful analysis of equipment profitability can improve the cash flow situation

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Every company, regardless of size, should have a continuous program of evaluating the profitability of company assets.

Once they become unproductive and fail to yield a satisfactory return, assets must be analyzed and disposition criteria established. Obsolescence, deterioration, and simple lack of use are several of the routine reasons that assets become unproductive.

Because of the current recession, our analysis situation will relate to a loss decision. The same approach would be valid for a profit decision. Profit and losses generated by asset dispositions are good methods of balancing income tax positions, and should be part of the overall evaluation.

Many companies hold dormant assets, and this article hopefully will stimulate a review and disposition of them.

Contractors’ cash balances are a premium asset today. Asset types range from these cash balances to fixed assets of machinery and equipment. The ability to convert assets into cash is referred to as its liquidity, with cash balances obviously being at the high end of the scale.

Fixed Assets

Fixed assets of land, buildings, and equipment are normally the least liquid in conversion, and will be the thrust of this analysis. Their marketability is restricted by many factors, including size, specific usage mobility, and economic conditions.

Assume you own a $25,000 piece of construction equipment with a depreciated book value of $18,000, and with a $21,000 remaining installment loan balance. The equipment has been idle for 90 days, and there are no prospects for its being job charged in the foreseeable future.

Expenses are charged to corporate overhead through an equipment account. Due to market conditions, the best purchase offer available is $15,000. A sale at this level therefore would result in a $3,000 operating loss and a $6,000 cash loss.

Before any meaningful decision, the first step must be a single economic analysis of sale of the asset versus holding it in hopes of a contracted usage. We want to establish the accounting point where an operating loss is equal to the loss resulting from the sale.

Indifference Point

If all other management factors remain constant at this point, you should be indifferent to selling the asset or holding it.

The following are our projected monthly operating expenses:

- loan interest $200;
- depreciation $100;
- insurance $100;
- storage $50;
- personal property taxes $75;
- routine preventive maintenance $50;
- licenses, etc. $10; giving us a total expense of $585.

(Even if you do not have an outstanding loan on equipment, you
must allocate some amount of monthly interest. The theory behind this imputed interest is that the cash invested in the equipment could be invested in some type of interest-paying assets if it were available. Thus, no asset analysis should be made without actual or imputed interest.)

From the above figures, our monthly accounting expenses are $585, and cash payouts are $485. The difference of $100 between the figures is depreciation, which is a non-cash expense.

As long as the equipment is idle, this expense continues to be general and administrative. At what point do the monthly expenses and cash payments equal those which would be generated on the projected sale?

The evaluation is:

Breakeven Accounting Loss

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\frac{3,000 \text{ book loss}}{585 \text{ monthly loss}} = 5.1 \text{ months}
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Breakeven Cash Flow Loss

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\frac{6,000 \text{ cash loss}}{485 \text{ mo. cash deficit}} = 12.4 \text{ mo.}
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In this particular exercise, our overall accounting expenses would be reduced by selling the equipment at a $3,000 loss, if it were to continue to remain idle for more than 5.1 months.

Cash flow would improve through immediate, outright sale if there is no prospect for job usage with 12.4 months. Because this is a loss situation, the sale generates the lesser loss, and this is a difficult concept to accept.

Contractors are fundamentally optimistic and resist making loss analysis. However, there are millions of dollars of cash to be freed up in dormant assets, even if it results in a reasonable loss.

Decreasing a negative cash flow or accounting loss can be as important a management decision as contract cost determination. It is a profit and loss analysis.

Cost Is Controlled

Decreasing cost of $585 monthly, or $7,020 annually is the same as being awarded a $46,800 contract, with a 15% markup. A company generally exercises more direct control over cost than revenue.

This is strictly an economic analysis, and there are other management evaluations in the final decision... ultimate availability of the equipment in the future is another key consideration.

However, the point of departure should be an economic analysis to determine various breakeven points. Review your assets on a quarterly basis and weed out those which are not profitable. Assets which are fully depreciated, or can be sold at profits, should be analyzed using the same approach. Determine the accounting point of indifference, and then weigh other management factors.

The important point is to continue evaluating assets and convert those not satisfying profit criteria into cash.