Rediscovering Asset Management

By A. Howard Heeman, C.P.A.

In 1976, the Securities and Exchange Commission mandated replacement cost accounting for the nation’s 1,000-plus largest corporations (those with gross property, plant and equipment and inventories of $100 million or more.) Surely you’re not in that class and you’ll join managements of the affected companies in complaining that strict asset control is burdensome and unnecessary.

But if replacement cost accounting has accomplished nothing else, it has at least made many contractors aware of serious deficiencies in their asset management systems. For instance: one company, with approximately $2 million of fixed assets on its books, responded to the new SEC regulation by fast undertaking a detailed survey of its assets. When the investigation was completed, management was shocked to discover that more than $900,000 of assets could not be accounted for. Roughly 4½ percent of the company’s fixed assets had, in effect, “disappeared,” in spite of the intensive survey and the fact that the organization’s asset management system was considered reasonably good.

The discovery would have come as no surprise to experts in the field of asset management. In fact, most of them would consider the company’s 4½ percent gap to be proof that the organization’s asset management program was indeed exceptional.

Gap Shows...

The typical gap between what the books show on an historical basis and what companies can actually account for on investigation is somewhere in the lo-to-15 percent range, according to many professional appraisers. On a national basis, that would mean that upwards of $80 billion of non-existent assets are being carried on the books of American businesses.

In spite of the enormity of that figure and the fact that it represents an extremely serious dilemma for every contractor, the problem remains in the theoretical realm. There are no hard figures available simply because most companies are blissfully unaware that their historical book figures are not in tune with reality.

But how could contractors, with steadily improving internal controls and the assistance of increasingly sophisticated electronic data processing systems, “lose” over $80 billion of its fixed assets? Basically, the answer relates to the priorities of internal controls.

Most companies, in their internal control mechanisms, give top priority to the elements of the business that are part of day-today operations: income, expenditures, inventories, cash, and so forth. Management of fixed assets all too often ends up at the bottom of the list. And all too often, when companies appraise the cost-effectiveness of various internal control elements, intensive management of fixed assets gets short shift in relation to other, seemingly more compelling considerations.

As a result, asset management, even among some of the biggest, and otherwise highly efficient, organizations, tends to become slipshod. With a low priority, the asset reporting systems between the production end of the business and the accounting department tend to break down.

For example, five years ago a curtain wall contractor purchased a piece of $25,000 welding/fabrication unit for its production line. The company was running close to capacity and the equipment was badly needed. Two years ago the unit broke down, at about the time that demand for the company’s products was declining. It was taken out of service as unneeded and moved to a corner of the factory. The company was in the midst of a belt-tightening period, so as other equipment on the production line broke down, workers cannibalized the...
unused unit for its parts. Last year, the shop form urged that the thoroughly cannibalized machine be gotten rid of. A superintendent authorized its sale for scrap, since in its condition it was virtually worthless for resale.

That was done, but no report was ever forwarded to the accounting department at the company’s headquarters. The value of the machine is still on the company’s books, where it may remain for years. Worse, the company has lost a quick tax write-down on whatever undepreciated value the machine represented after only five years of service.

Perhaps the most damaging effect of the assets gap is its impact on the management decision-making process. If a 10-to-15 percent gap is typical, the top executives of the average construction company are being seriously misinformed about the condition of their organization.

If management decides that a 15 percent margin is necessary for the company’s well-being, it may be impelled to raise prices in the belief that there is little alternative. Had management realized that the company’s real return on assets was very close to the desired level, it might have had a very significant impact on the pricing decision. We recognize, of course, that many other factors must be considered in weighing price changes, but return on assets is usually a very important part of the decision-making process.

Can Mislead . . .

Expansion considerations can be similarly affected by such misinformation. For example, if a company is considering, say, a 20 percent expansion of its operations, it can be badly misled about the costs of that additional capacity if it used erroneous fixed asset figures for projecting the investment necessary to achieve its goal. This could result in rejection of expansion plans as too expensive for anticipated returns.

But all of this is theoretical damage. “Ghost” assets can also represent a very tangible and sizeable financial drain, in such costs as additional insurance premiums (not to mention failure to claim losses where theft or damage is unreported), higher-than-necessary property taxes, and outright waste of money.

Improper asset management may also be costing American businesses billions of dollars in theft loss deductions on business income tax returns. A theft loss deduction requires a probability of criminal activity. Obviously, if a company can’t even determine when an asset was lost, it can’t very well establish how that loss occurred.

When the SEC required replacement cost accounting of the nation’s largest companies, some of them initiated extensive physical inventories of their plant and equipment (as in the example cited at the beginning of this article). Many contractors, unfortunately, did not undertake such physical inventories as part of the replacement cost exercise.

The latter group of companies simply accepted historical cost records as accurate, and indexed their figures forward to account for inflation in order to arrive at replacement cost estimates for the SEC’s reporting requirement. In cases where there were substantial amounts of non-existent assets on the books, the distortion was passed along, and magnified, on the replacement cost report.

Without a physical inventory of assets, the gap between real and reported property, plant and equipment figures will continue to perpetuate itself. Unfortunately, a regularly-scheduled, methodical inventory of fixed assets is becoming a relatively rare practice among American bus-
inesses. Many companies haven’t undertaken such inventories in a long time. Some companies, in fact, including major corporations, have hardly ever undertaken such an exercise in their entire histories.

**Proper System?**

But what does a proper system of asset management consist of? Very simply, it is a system whereby the progress of fixed assets is recorded from purchase to utilization to disposal. This requires a constant line of communication between operating personnel and the accounting department. It is in that line of communication—that reporting system—that most asset management systems break down.

However, some of the most serious, and costly, errors occur at the accounting end of the system. A good asset management program requires careful classification of assets, at the very least for depreciation and investment credit purposes.

Many elements of plant construction are eligible for both investment credit and accelerated depreciation. These are the parts of a plant that are directly attributable to production processes: electrical wiring, process heating and cooling equipment, special foundation work for supporting machinery, and many others. In some high technology fields, 50 percent and more of a plant’s construction costs may be eligible for investment credit and accelerated depreciation, a fact that would reflect directly on a company’s bottom line.

Where such benefits are missed, it is often due to the failure of the asset management system to properly classify the various elements of plant con-
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If asset management is given low priority in a company’s internal control system, such errors have to be expected.

Low priority also has an impact on the reporting system, which, as we mentioned earlier, is the most consistent source of breakdowns in asset management. If management assigns low-level accounting staff to asset management, which is not uncommon, it may be read by both accounting and operating personnel as a sign that management has minimal interest in the viability of the function. This can have a negative psychological effect on everyone who is expected to play a role in the asset reporting system. If employees feel that management is not thoroughly committed to a reporting system, almost invariably the system breaks down.

And this leads to a very important factor in the assets gap: employee theft. In a business atmosphere in which equipment is treated haphazardly, both in the office and the plant, employees are almost encouraged to steal. When unused or damaged equipment sits gathering dust, when there is no apparent system of accountability, assets will invariably disappear, if only because the risk of discovery seems minimal.

In a proper system of asset management, the reporting system is given a high priority by top executives. All equipment above a given dollar value is coded and numbered. Employees are thoroughly instructed that any change in the disposition of equipment, whether it is disposed of or transferred to another location, is to be recorded and reported to the proper authority.

Each department is required to maintain proper records and conduct an inventory of equipment on a regular basis. This type of operation instills in employees an awareness of the organization’s concern for all of its assets. It discourages theft by making it obvious to employees that the disappearance of assets will not be overlooked for long.

Theft Loss Deductions

It also can be beneficial to a company in claiming theft loss deductions on income tax returns. If a company maintains detailed records of the disposition of all its assets, an inexplicable disappearance of equipment can rationally be attributed to theft. Although there is never any guarantee that the tax authorities will allow a theft loss deduction without an accompanying police report, detailed records that establish some probability of theft may give a company at least the benefit of the doubt.

Reasonably good asset management systems invariably take some time to establish. If they are to succeed, a physical inventory of fixed assets is a highly advisable first step.

It is also advisable, although certainly optional, for all companies to follow up a physical inventory of assets with a replacement cost exercise.

Replacement cost accounting can be a very useful exercise, particularly for smaller, fast-growing companies. It can provide extremely valuable information for management decision-making, within the context of a well-designed asset management program.

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