

## Give Me A ‘C’ --

### Why capitalization is not a four-letter word

By Thomas McLaughlin

Source: *The Nonprofit Times*, July 1996. Reprinted with permission.

The top candidate for the most under appreciated (pun intended) area of non-profit financial management is capitalization. Nonprofit managers historically have paid scant attention to this aspect of their operations.

For one thing, most nonprofit organizations don't do things that require capital expenditures – or at least they don't think they do. For another, only the larger nonprofits, such as universities and hospitals, have access to the bond markets, which is what typically prompts serious attention to capital structure.

Finally, some percentage of nonprofit managers share a frequently unspoken discomfort with the whole idea of capitalism or anything that smacks of it.

Ironically, next to maintaining cash flow and profitability, using the capital entrusted to it is perhaps the most important financial choice a nonprofit organization will make. To a degree that varies with the services the organization provides, one use of capital is to acquire assets such as property, plant and equipment. Analyzing that choice turns out to be easy.

### Analysis and how it works

Let's go right to the punch line and work backwards from there. Your de facto policies toward capital asset acquisition and management is called the accounting age of property plant and equipment, and it can be inferred from your most recent IRS Form 990.

Find line 57c, accumulated depreciation, on the form and divide it by line 42 column A, depreciation expense. The resulting number tells you a lot about your capital asset management policies. The higher the number, the older your property. The lower the number, the more up to date your investment.

#### The Formula:

To calculate your accounting age of property, plant and equipment, use the following formula:

$$\frac{\text{Accumulated Depreciation (Line 57c)}}{\text{Depreciation (Line 42A)}}$$

The answer is expressed as a number of years – 7.2 years, 9.0 years, etc. Being an average, this does not mean that every asset owned by the organization is 7.2 years old. The mixture of assets owned is an important variable. The more the mixture is weighted toward bigger, longer term assets the higher the number will be. For nonprofits with only office furniture and miscellaneous equipment as capital assets, the number should be in the low, single digit range.

Although nominally measured in years, this number is really an index, a pure number whose greatest usefulness is its size (as well as the way it compares with the same index from other comparable groups – more on that later). Here's why.

When you purchase a capital asset – normally considered to be a thing of value that will last much more than 12 months, such as a piece of real estate, a large item such as a computer, or a motor vehicle – the asset goes in financial records as the cost of its acquisition.

So a building that cost \$100,000 will show up on the balance sheet as an asset worth that amount (although it will usually be grouped with similar assets, so it may not be possible to identify that asset separately). Note that it doesn't make any difference in this area how the asset purchase was financed. Only the purchase price is important.

For financial purposes, assets are regarded as having a limited life span. This is known as the useful life of the asset. Further more, each year the owner is considered to “use up” a portion of that asset. This is called depreciation.

Almost always in the nonprofit sector, depreciation is calculated by dividing the cost of the asset by its useful life. If that \$100,000 asset had a useful life of 10 years – useful lives are usually calculated for you by the IRS – then depreciation is considered to be \$100,000/10, or \$10,000 per year. Each year the organization must show \$10,000 as an expense of doing business.

If a nonprofit only owned one piece of capital equipment, keeping track of depreciation would be a cinch. But assets are acquired every year, and after a while old assets are fully depreciated, which means that they no longer show up on the balance sheet. Plus, virtually every active asset originally cost a different amount and is at a different point in its useful life.

The result is that each asset must be tracked separately and the totals lumped together to create an overall total for the year. This is what is meant by the schedule of depreciation.

Adding the total amount of depreciation registered by all active assets gives the agency's total depreciation expense for that year, and that's what is shown in line 42 of the 990. Adding together the total amount of depreciation charged to date against each individual asset since it was first acquired gives the accumulated depreciation shown in line 57b. Dividing line 57c by line 42A gives the accounting age of property, plant and equipment.

### **What it means**

This is all more than an exercise in division. The accounting age of property, plant and equipment is effectively a guide to the time frame by which the organization is managed.

One of the first places that financially pressed managers often cut is capital expenditures – putting off that renovation, buying one vehicle when two are really needed, and so on.

Capital expenditures are “big ticket” items so they are a natural target of budget cutters. But, perhaps more important, the effect of going without a needed asset can be subtle and take a few years to show up.

Hospitals, for example, must make routinely large investments in buildings and equipment to attract and hold physicians who make referrals. In turn, those referrals generate revenue, which generate profits, which allow further capital investment to attract and hold physicians, etc.

Stretching the investment cycle in the name of saving money – i.e., letting the accounting age of property, plant, and equipment drift upward – can mean the beginning of gradual decline for the organization.

Other types of organizations will find this measure useful as well. Groups that provide residential care and who purchase their own facilities will find the ratio extremely helpful in monitoring their performance.

In these cases, the absence of a meaningful ratio will be equally significant., since a residential care provider that rents every single one of its buildings necessarily has a dramatically shortened time horizon for its programming – the end of its leasing period.

### **“But we don’t own anything”**

With proper care and analysis this test can be applied to organizations that own no real estate and don’t need to invest in expensive specialized equipment. Why? Because almost every organization today needs to make regular investments in computer equipment.

Considering that information technology usually has a useful life of three-to-five years, if computers were the only significant type of capital asset that an agency were to buy, an accounting age of more than five years would suggest that the organization is falling behind in its information processing capability. A quick walk around the office would probably confirm that hypothesis.

Finally, the accounting age ratio is ideally suited to comparisons with comparable organizations, or benchmarking. Knowing others’ results can be an invaluable guide to planning since the simple mathematics of accounting age ratios means that they will tend to change gradually over time rather than abruptly.

Knowing benchmarks also helps put an individual agency’s results into contest. National and statewide associations are often good sources of benchmarks, as are consultants and researchers.