Incentivizing Asset Disposal: A Cost Allocation Methodology

BY STEPHEN J. MICHELSEN, CPPA, NPMA Executive Vice President

In an article titled "Asset Management: Incentives for Better Control," Volume 9 Number 2, I postulated that improvements in asset management will only occur as organizations institute reforms which transfer the life-cycle capital costs of assets to the lowest possible user account.

I suggested that instituting a system of user charges for personal property items received, as well as infrastructure support costs for assets in storage or not in use, will encourage the most efficient usage of personal property. As indicated in that earlier article, I feel strongly that the application of such property burden expenses to user accounts would represent a significant incentive to stimulate action to redistribute, sell or otherwise dispose of underutilized and unneeded personal property.

The key objective in this approach to asset management is to make all of the costs of asset ownership visible to the managers who represent the end users. As managers and users come to appreciate the life-cycle costs of the assets they acquire, use, maintain and warehouse, they should make more value-based retention decisions during the life of the asset.

As a consequence, it could be expected that at the point where the cost of preserving the asset exceeded its value (including all charges to the user), the increasing cost burden of the asset would drive the manager to dispose of it.

The earlier article has stimulated significant discussion within the National Property Management Association (NPMA) community. I am always impressed when an article in The Property Professional has the broad impact that I have seen evidenced as I have addressed various public and private organizations in the last several months. Clearly our NPMA membership reads these articles with great enthusiasm and significant analytical ability. In addition, I am finding that there is an unquenched thirst for the "full" story. It is clear to me that when we contribute articles to The Property Professional, we need to go beyond the theoretical and reduce our ideas to practical applications. Our members want to know "How do I make this happen?" Given the space limitations and time constraints involved in the publication of a bi-monthly magazine, in some cases it may be necessary to publish more than one article on the same subject to fully develop the concept and its application. In fact, I am writing this second article to more fully develop my original thoughts on asset management and disposal.

Introduction

While I have answered numerous questions relating to the asset management article, the most common question concerns a search for a process to compute the full cost of property ownership and how to translate that cost to local managers. I have given the question much thought and have asked other professionals for their ideas. We all feel that the many site specific variables (e.g., inventory magnitude; accuracy and systems capability; accounting systems design and practices; and budget allocation practices and management support) combine to subvert any attempt to design a "silver bullet" or general purpose model. However, there is enough commonality in our discussions that I feel comfortable in describing a strategic design that can be modified to accommodate many (but perhaps not all) of the variables unique to specific applications in the public and private sectors.

Perspective on the Problem

Many organizations have significant amounts of property already identified as excess to user needs yet it remains in the inventory. In addition, in those same organizations it is often the case that there are additional quantities of unused or underutilized property which has never been identified as excess and it too remains in the inventory. In both cases, managers are not taking the necessary actions to either dispose of known excess property or to identify additional quantities of property for reutilization or other disposal actions. It is apparent that public and private sector managers are reluctant to declare property excess to their requirements.

Generally, all organizations have internal guidelines that require the efficient utilization of property. The question then arises as to why there is clear evidence that managers are not following the guidance. While the causes are varied the answer to the question is relatively simple. Basically, behind every resource allocation decision, a manager makes some calculation as to what costs are associated with a particular action. The most fundamental issue facing asset managers is valuing assets in place.1

It is my experience that when asked to explain how they determine the relative value of assets most managers and end users offer three factors for consideration. First, we have to recognize that there is an unbudgeted cost to the user for preparing excess property for dispos-
al. The financial and “sweat equity” costs can be significant. Depending on the type of property it may have to be cleaned, repaired and safety inspected prior to disposal. The effort associated with those tasks can be time consuming, laborious tasks; require funds to be drawn from competing activities; and detract from the organizations "bottom line." Often, managers avoid the problem by simply saving the property for future use (and keeping it out of the excess inventory) or declaring it excess and moving it to interim warehouse storage. In actuality, the costs associated with disposal may exceed the apparent costs of storage, especially if the storage is in an office or laboratory rather than a warehouse.

A second observation is that end users often retain currently unneeded property items in anticipation that it may again be needed at some time in the future. However, the "future" is vaguely defined and the property remains part of the inventory indefinitely. This approach to asset management is especially common when the property involved is difficult or expensive to acquire. As managers consider the cost versus benefits of various disposition options, the "rust-in-place" approach often appears to be the answer. The cost of preparing property for sale and the associated warehouse charges seem to be much greater than the hidden overhead burden of retaining the property in the laboratory or office.

The managerial behavior described above, while logical to the individual manager, is clearly not rational when one considers the greater cost implications. The costs of asset management that are relevant for managerial decision-making are those that would be incurred if one action were taken but not incurred if it were not. Similarly, the potential cost avoided or revenue of an alternative action is the extra value that could have been realized if the alternative decision were made rather than not made. 2 The important point to be made is that both costs and returns (value) relate to course of actions that managers and end users choose when considering disposal options.

There are assorted real and abstract costs associated with on-site storage. For instance, every organization computes a cost for occupied office and laboratory space. To the extent that such facilities are, in actuality, larger than needed to perform necessary work, that additional space is an excess charge made directly to the organizations accounts. When that added space requirement is predicated on the need for space to store unneeded or questionable “future use” property, the additional expense is not immediately apparent to those in authority above the users organization and probably is unjustified.

**The Cost Allocation Models**

The cost allocation models are tools that can be used as incentives for managers to reduce asset levels. They are based on the principle that managers will dispose of unneeded assets when the cost of retaining the assets is greater than the cost of disposal. They are simple economic models that have predictable outcomes. If an organization assesses each end use manager an annual storage cost on all acquired property, it can be assumed that rational managers will quickly move to dispose of property which is not essential to the conduct of ongoing work.

One approach is to assess user fees associated with individual items of property under the control of the user. This approach, the User Fee Model, requires inventory management systems with a high level of sophistication and accuracy. Generally, it is applied "as of" a certain date because of the difficulty validating the accuracy of the data in the information systems currently in use.

In fact, its logic assumes that a very small percentage of the unneeded property in the inventory has not been identified as excess. To the extent that there is a significant quantity of “excess” property that remains hidden, this approach will fail to impose charges sufficient to motivate management actions toward identification and disposition.

A second approach, the Space Utilization Model, avoids the difficulties and shortcomings of the User Fee Model. It is based on the assumption that office and laboratory space is partially dependent on the floor space occupied by utilized, underutilized, and unneeded property. Quite simply, the Space Utilization Model approach is to charge managers for the space they use. The assessment of such a charge sends a clear message that there is a real and immediate cost to pay for holding assets in excess of current needs. The individual manager is left to decide if the cost of holding the asset in "hidden storage" is less than the long-term benefit that might be derived through some future application of the asset.

Benchmarks are available from the Defense Logistics Agency and other sources. The charges are based on regional commercial storage costs. To the extent that one might debate the absolute of the charges, the accuracy is irrelevant. Any serious debate as to whether it is $6.00/sq. ft or $6.50/sq. ft. misses the point. The impact on the manager is the actual institution of the storage charges. In addition, the corporate assumption regarding the percentage of inventory held in "hidden storage" has to be factored into the costing model. The charge per sq. ft. times the presumed "hidden storage" ratio gives both a holding cost rate and a baseline against which to measure managerial action to reduce the inventory.

The Space Utilization Model has some very positive benefits. It is simple to institute and doesn’t require the management information systems capability needed to assess user fees. In addition it can reduce the need for facilities and save operation, maintenance and lease costs. Further, it can generate revenues from the sale of
surplus assets. Studies have shown that $1 of surplus sales has the same impact on the organizations bottom line as $11 of direct product sales. On the other hand, the Space Utilization Model can be criticized by individual managers who are assessed storage charges on equipment not in their inventory. Fairness and equity become an issue. However, at least in the early years of implementation of the model, it is safe to assume that almost every office will have some unneeded "hidden inventory." To the extent deemed necessary and justified, accommodations can be made in later years to reduce the burden on the managers demonstrating the greatest success in meeting inventory reduction goals.

The application of the Space Utilization Model will demonstrate to managers that asset use and retention involves significant costs to them and their parent organizations. The measurement of their performance managing assets, as evaluated against selected benchmarks, can help them reduce their operating costs. The end product is a "win-win" for the users and the parent organizations. Unneeded property is disposed of by reutilization or sale; space needs are consolidated; inventory costs are reduced; and associated operational costs can be justified against "world-class" performance as indicated by the benchmark scores.

Financial Accountability

Pressuring managers to reduce the size of the inventory of unneeded property without providing a source of funding for the disposal preparation costs could have negative consequences. The most obvious would be the managers exercise of discretion regarding the reallocation of available funds from mission work to asset disposal. Less mission work may get done as funds are assigned for the purpose of inventory reduction. To avoid this possibility, the program sponsors who acquired the assets should be charged for the disposal of the assets when they are no longer needed. In addition, to the extent that the assets have value at sale, any proceeds from their sale should be returned to the sponsoring program’s account.

Sometimes inventory records cannot accurately identify the program sponsor, or the sponsor, while known, no longer exists as an organizational element. It is not unusual for programs to be terminated for funding and other reasons. In addition, organizations are acquired or merged with other business entities and the lines of accountability are clouded by multiple transfers of functions. As a consequence of both of these scenarios, the individuals associated with the use of the property move to other work and their funding responsibilities for the program’s costs are ended.

In cases where financial accountability cannot be determined, two approaches can be applied. First, where a specific program was canceled but the corporate organization that manages all such work still exists, it should be charged with the costs of disposal. Secondly, when there can be no direct attribution to a corporate sponsor, the necessary disposition preparation costs should be charged to a central fund established for that purpose. Specifically, all programmatic activities within an organization should contribute to the fund, based on a percentage of their annual costs of asset acquisition. The balance of that fund would be available in perpetuity, not withstanding the survival or demise of the contributing organizations over time.

Conclusion

Through the application of the Space Utilization Model set forth in this article, organizations can create a system of asset management that stimulates managers to identify unneeded and underutilized assets. These actions will create meaningful incentives for managers to perform better at reduced costs by: avoiding acquisition costs through increased asset reutilization; generating revenue from asset sales; avoiding fines and penalties by reducing the unnecessary retention of environmental wastes; and consolidating warehouse space. While the methodology proposed may draw criticism from affected managers and end users, I hope that through the publication of this article I can engage both critics and supporters in a meaningful dialogue.

An open discussion of this approach may reinforce much of what has been published or, in some cases, convince the supporters of the Space Utilization Model that a revised approach is required. In the end, those organizations responsible for asset management will be able to consider, and maybe adopt this approach: one which will reduce the cost of operations and be "endorsed" by the knowledgeable property professionals of NPMA.

Footnotes

References