Take Action Series

How To Analyze Fixed Asset Purchases

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the business knowledge center
Go-To Solutions for Small Business

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Overview

One of the most challenging business management responsibilities faced by business owners involves making decisions regarding the purchase of long-term assets. These decisions typically involve a significant commitment of a company's capital. The acquisition decision could be for; new equipment, rebuilding existing equipment, acquiring new business vehicles, or constructing/buying/remodeling a facility to name a few. The important point to remember is; the owner(s) is contemplating making an investment in an asset form that will tie up cash for a long period of time.

The objective of this manual is to introduce business owners and managers like you; to commonly used techniques that will enable you to evaluate the feasibility of making investments in long term assets. The use of these tools/techniques will help you justify the business reasons for your investment decision.

EXPERIENCE REVEALS THE MOST SUCCESSFUL AND VALUABLE BUSINESSES are those that can predictively generate sales, operating profits and internal cash flow. The assets they acquire to support sales, like receivables and inventory, are productively utilized and their funding requirements are structured to be cash flow affordable. One of the business management battle cries we preach at the Knowledge Center is "NO LAZY ASSETS." This is especially true when you consider fixed asset acquisitions impact a business' cash flow for years.

Business owners should NOT be in the asset acquisition business. They should be in the asset utilization business. Assets are simply tools used by business owners to generate sales and ultimately make a profit. Most everything else about them is bad; they house cash, they require funding, and they require care and maintenance. To add insult to injury, they typically depreciate over time.

Owning/operating a business is taking a risk. The acquisition of assets should economically justify the risks associated with owning/operating that business. The decision to acquire long term assets should link to a cost/benefit analysis that justifies the expenditure.

A pervasive behavior pattern we see in business owners is their absolute desire to substantially mitigate, if not eliminate the need to pay business income taxes. Their primary strategy to reduce taxable income is to find additional tax deductions. Acquiring depreciable assets is a common way to lower taxes because the costs associated with acquiring them, can be deductible.

Acquiring assets takes capital; capital this is either supplied by business owners and/or is borrowed from their financial services provider.

Net Present Value

The biggest shortcomings of the two previous capital budgeting methods is they ignore the time value of money. Remember, you're investing today's dollars for an anticipated return in the future. We previously discussed the theories of compounding and discounting. A dollar today is worth more than a dollar sometime in the future. That brings us to the Net Present Value Approach.

The **Net Present Value Approach** takes into consideration the time value of money. It utilizes the PVIF to determine what future dollars are worth in today's terms. This approach compares the initial investment's present value against the present value of anticipated future inflows; resulting in a net present value. If the net present value is equal to or greater than zero you should accept the project. If the value exceeds zero it tells you, you're meeting or exceeding your required rate of return. The required rate of return you establish should be based on the risk associated with the project.

A Net Present Value Approach typically looks something like this:

PROJECT:			REQUIRED RATE OF RETURN:	
	NET CASH FLOW	X	PVIF	PV OF CASH FLOW
Year 1		X		
Year 2		X		
Year 3		X		
Year 4		X		
Year 5		X		
Year 6		X		
Year 7		X		
Year 8		X		
Year 9		X		
Year 10		X		
			PV of Inflows:	
			Less: Cost:	
			Net Present Value:	

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