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Understanding Accelerated Depreciation (part I)

One of the more important changes in tax legislation passed by President Bush is scheduled to expire this year: Accelerated Depreciation of Capital Investment.

No one is even remotely suggesting that anyone do some thing about this sunsetting on December 31, 2004. Nor are they likely to, for reasons that will become abundantly clear later.

Most investors seem to understand very little about what is, at its heart, a change in the rules governing certain accounting operations. Surprisingly, we've seen very little in the way of analysis or commentary on it from the Wall Street; Nor has there been much said in the financial press about what is essentially an intriguing corporate tax cut.

Let's see if we can change all that.

What is Accelerated Depreciation?

When making large capital purchases, businesses get to write them down over time, deducting their original cost, based upon certain schedules and accounting conventions. This is called "*Depreciation*." If that word sounds familiar, it should: Depreciation is the "D" in EBITDA (*Earnings before Interest, taxes, depreciation* and *amortization).*

For those of you whose eyes glaze over at the mere mention of accounting, consider this: What would it be like if you could write off big-ticket purchases *much faster* than your accountant was able to do historically? What would you buy if you could deduct the lion's share of the equipment purchase expenses in year one -- instead of the usual *seven*? And this deduction covers just about everything bigger than a Blackberry, and smaller than real estate – even a **Lear jet** . . .

Have I got your attention yet?

All that and more is what the accelerated depreciation of capital investments entails.

Let's drill down into the details: Traditionally, major capital investments were "depreciated" based upon a rough schedule of their useful expected lifespan. For example: a laptop is expected to last 3 years; Telecom switching equipment should be around for 5 years; And large trucks or construction vehicles are expected to last 7 years. (Any accountants out there -- feel free to send me other examples you think are more illustrative, or tell me why my expectation on these three are wrong).

To grossly oversimplify how these purchases get "written down," imagine your firm needs to buy a large (and fictional) **widget doohickey**. It costs about a million dollars, and should last you 5 years. Straight-line depreciation means that you get to deduct the expense of about a fifth of the purchase price each year for 5 years. (Green Eyeshade people – hold your cards and letters; Yes, I know I am oversimplifying this, otherwise we would bore these poor bastards to death; It's accounting minutia, for crying out loud).

If you were to buy this **widget doohickey** in 2005, you would get to write down $200,000 that first year.

Under *accelerated depreciation*, however, you get a bonus: 50% of the purchase price. And all you have to give up is half of the first year's usual depreciation.

What does that look like for our million-dollar thingamajig? Instead of depreciating $200k in year one, our lucky accountant gets to write down $600k: The 50% accelerated depreciation, plus half of the usual 20%.

That's an enormous difference.

50% Accelerated Depreciation bonus versus Ordinary Depreciation			
Capital Purchase	Depreciation Schedule	2004 Purchase (% write down)	2005 Purchase (% write down)
Laptop	3 years	**67%** (50% + 1/2 of 33%)	33%
Router	5 years	**60%** (50% + 1/2 of 20%)	20%
Earth Mover	7 years	**57%** (50% + 1/2 of 14%)	14%

The key is that in order to qualify for the 2004 depreciation schedule, the capital equipment must be "Placed in Service" by that 12/31/04 -- not merely ordered, or sitting in a warehouse, but in actual use.

The impact on corporate balance sheets is so large, any firm that misses this opportunity to purchase needed equipment would be foolish not to do so this year. As I mentioned the other day on Squawk Box, every CFO in the country should be calling their Chief Information Officers and Chief Technology Officers into their office, and demanding to know what planned 2005 purchases can be "pulled forward" into 2004.

This is why I believe all the hand wringing over the inventory build up is just so much chicken little: Inventory build is a problem when it occurs in customers' warehouses. It is exceedingly hard to sell something when the prospective buyer has millions of the item for sale piled up on loading docks around the World.

When inventory build up occurs at the manufacturers' side, however, that's an indication they are expecting an upswing in orders. It takes strategic planning -- and some optimism about the future -- to produce an inventory build. The risk factor for corporate manufacturers is one of margin pressure. If sales do not materialize, then prices will need to be cut to move the goods. The goods will get sold –eventually – but at less of a profit.

But consider the opposite: What happens if demand picks up, but you have no inventory to sell? Those lost sales are gone forever.

Why were the Accelerated Depreciation accounting rules changed?

In the years leading up to market bubble, there was a massive build up in productive capacity. By 1999, the watchword was becoming "over-capacity." Corporate America had the ability to produce far more than was necessary to meet demand.

It wasn't just tech and telecom, either: From the chemical industry to industrial manufacturing, nearly all sectors were seeing signs of excess capacity. They had built the infrastructure to service more demand than actually existed. Except for a few grumpy old bears, no one on Wall Street seemed to care very much about it.

The run up to the top saw too much capital chasing too few ideas. The result was an excess capacity Then came the crash, followed by the recession.

In the immediate aftermath, businesses had a precipitous drop off in new orders. Given the how massive the bubble was, a real possibility existed for a prolonged capital investment slump. The new depreciation rules were designed to temporarily soften the impact of post-bubble environment.

Excess capacity can be squeezed out of the system only through the passage of time, and concurrent increase in end user demand.

Conclusion

Although the economy is expanding, it is hardly growing at a robust pace. That could see a positive change soon. A potential surge in orders may hit late in the 4th quarter, as corporate management rushes to take advantage of this rule before its expiration. In particular, we note the impact of the depreciation rule in Semi-conductor equipment, Telecom, and Industrial manufacturing.

Coming in part II:
We all know there's no such thing as a free lunch. So what are the negative, unintended consequences of the changes in the Accelerated Depreciation rules? Reverse channel stuffing and deferred hiring are the two big ones. We will look at these in the coming weeks.

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