Capital Budget Planning

Simple Management Solutions, LLC.
Integrated Facilities Management
and Design

Ian Bigelow

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Budgeting for capital expenditures (capex) is essential for a business to operate efficiently and grow in a strong and cost-effective way. Capital funds are funds used by companies to acquire, upgrade, and maintain physical assets such as property, buildings, technology, and equipment. Capital funds are often used to undertake new projects or investments. Making capital expenditures on fixed assets can include repairing a roof, remodeling a workspace, purchasing a piece of equipment, or building a new factory. This type of financial outlay is also made by companies to maintain or increase their operational capacity and scope.

A capital expense is the cost of an asset that has usefulness, helping create profits for a period longer than a single tax year. This distinguishes them from operational expenditures, which are made for assets that are purchased and consumed within the same tax year.

For example, printer paper is an operational expense, while the printer itself is a capital expense. Capital expenditures are much higher than operational expenses, covering the purchase of buildings, equipment, and company vehicles. Capital expenditures may also include items such as money spent to purchase other companies or for research and development. Operational expenses are just what their name signifies, the expenses required for the company to operate from week-to-week or month-to-month.

Capital expenditures have the potential to be both good and bad. Investing in capex can improve the efficiency of a firm, can allow firms to gain a competitive edge. On the other hand, they may fail to perform as expected, resulting in losses that might have been better allocated elsewhere.

It's important to create a sound capital plan to avoid any expense overruns, because capital expenditures represent substantial investments of cash designed to show a return on the investment (ROI) over a planned period of time, they need to be carefully vetted. Taking into consideration all costs, market expectations, business growth, workflow and efficiency improvement for each expense is crucial when drafting a capex plan.

Capital Expenditure Planning
The processes for preparing a capital budget can vary considerably between companies, depending on the nature of the company's business, the size of the company, risk tolerances, cash flow, cash reserves, ROI expectations, internal rate of return requirements and a host of other possible determinants. All of these have to be carefully considered in the development of a viable plan.

Separating Expenditure Budgets
Most companies budget their capital expenditures separately from operating expenditures. Having a separate budget from operational expenses, for example, makes it simpler for companies to calculate the respective tax burden. For operational expenses, tax deductions apply to the current year, and are based on acquisition value, but deductions for capital expenditures are spread out over the course of years, based on the expected lifespan of the asset.

Capital assets are setup on the balance sheet for a preset number of years equal to their expected useful lifespan. The initial value of the asset is allocated over the planned number of years. Each year the value of the asset declines by the amount apportioned to a single year as depreciation or amortization. Depending on state and local laws, tax assessments and deductions for these assets can be impacted in different ways:

1. Property tax charges are usually based on a set rate per thousand dollars of residual net book value (NBV) of an asset at the end of each year's depreciation, over the course of its useful life. By this method, the property tax burden declines with the depreciated NBV of the asset each year.
2. Conversely, a tax deduction can usually be claimed based on a % rate applied to the allocated expense of a single year of depreciation.

Unfortunately, all applicable sales taxes are applied at the time of purchase, regardless of the expense being operational or capital in nature.

Department Input
The determining factors for capex need come from the operational assessment of workflow and efficiency at the department level. Department heads are best able to assess any issues that would benefit from acquiring, updating, or replacing capital assets within their space. This must be an outcome-based assessment focusing on process improvement and efficiency to determine whether any capex expenditures will be beneficial to long-term growth. What is economically feasible, and what the return on the investment will be are critical considerations. In the end, capital expenditures are inevitably determined by upper management and owners.

Implementing a Budget Limit
No company has unlimited access to cash, so determining what resources can be made available to a capital budget must be among the first steps. Making a prioritized, comprehensive assessment of companywide need, complete with verifiable calculations for acceptable ROI done for each asset or project to be funded, whether for maintenance, new acquisitions, or growth, is the best way of determining how much to budget for capex. Once a company decides on a spending limit, the plan can be developed around that.

Measuring Capital Expenditure Returns
Using MS Excel and Access, I have written effective tools for assessing the returns of capital expenditures, particularly the timeframe in which the investments will start to payback. Return on investment ratios, hurdle rates, and payback periods are vital areas to analyze when determining the benefit of a capital expenditure. At a minimum, the ROI from capital assets, should nullify their cost over a shorter period of time than that set for its useful lifespan on the balance sheet for depreciation.

Management's Role in Capital Expenditures
Capital budgeting can involve exceptionally large expenditures, and senior management must decide if the investment is worth the cost. Capital expenses almost always impact operational expenses as purchased items need to be maintained and the "cost of ownership" must be considered.

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Once the capital budget and a list of items to be funded is complete, senior management must decide if the cash reserves for the company are sufficient to cover the cost of implementation, finance the plan. Financing increases the debt level of a firm. Additional debt service needs to be taken into consideration when determining ROI. Leasing can be an appealing option if a company is purchasing assets such as computers or other technology equipment items that can quickly become obsolete. It is not unusual for capital acquisition resources to come somewhat from each of these approaches. Do what makes sense for your company.

Capital budgeting decisions give a look at the direction the company plans to go in the years ahead. Consequently, capital budgets are commonly constructed to cover periods of 5 to 10 years. Nevertheless, it is important to go through the process every year to confirm and adjust the plan to meet the needs of the enterprise and its vision as it continues to evolve.

The Bottom Line
Capital expenditures are a large but necessary cost for a company. They come with many benefits and many risks, which is why it is imperative to create a sound and thorough plan that takes into consideration all variables. If done and executed correctly, it can lead to positive growth and success.

The right professional
Finding the right person to help a business identify and prioritize the strategies that are critical for success throughout every stage of the operation is difficult, but nonetheless essential. I believe myself to have the qualifications and skills to fill that role and I would like the opportunity to prove it.