THE MYSTERIES OF CAPITAL BUDGETING

By GUDRUN GRANHOLM, Box One, Inc.

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In the last column I discussed some of the key points for winning your business case. One of the least understood aspects of winning your case revolves around the type of approval a project needs.

Operating v. Capital Budgets

Most organizations have two budgets – an operating budget and a capital budget. The *operating budget* is a forecast of next year's sales and expenses. It's essentially a plan for next year's Income Statement (internally referred to as Profit and Loss Statement). A project that requires expenditures impacting only the current year will normally be approved as part of the regular operating budget.

So, what's a *capital budget*? The whole purpose of the capital budget is to deal with projects that have impact on the financials for more than one year. For this reason we generally refer to expenditures shown in capital budgets as "investments".

"To Expense or To Capitalize", that is the Question

There's often confusion about what these two words really mean. One simple way to view them is to understand which financial statement they impact. *Expensing* means we're working on the Income Statement, *capitalizing* means that we're dealing with the Balance Sheet. The key question is: *will the expenditure (investment) have a benefit for more than one month?* If no, then we'll "expense" that item. If yes, then it will be "capitalized" on the Balance Sheet. This is the same logic that explains why something is either in the Operating Budget or in the Capital Budget. If it impacts only the current year, it's the Operating Budget. If it impacts multiple years, then it's in the Capital Budget.

A Practical Example

After extensive preparation, your proposal for creating a pilot program using remote monitoring has been approved. To illustrate, a portion of the investment required includes a $300,000 investment in software, a $360,000 investment in hardware infrastructure, a $120,000 annual service contract, and $20,000 for the monthly rental of the monitoring center.

The main question in accounting is "over what timeline will *each* of these expenditures benefit the company"? The *monthly rental* is easy. Each $20,000 rental payment covers just one month, so the benefit is only a month long. As a result, every month the rental payment is immediately charged as an expense on the Income Statement (or P&L). But what if the first check is sent out in June to cover the July rental payment? For the June financials, this will show as a "prepaid expense" on the Balance Sheet. In July the prepaid asset will be charged off the Balance Sheet and "expensed" on the Income Statement to match up with the service period the rental payment is actually covering.

The *annual maintenance* contract for $120,000 is also fairly straightforward. While the cash is paid at the beginning of service coverage, the benefit (or "insurance protection") is over a whole year. So the payment is "capitalized". It becomes a "prepaid expense" for the Company, sitting on the Balance Sheet. Every month accounting reduces the amount on the Balance Sheet by $10,000 ($120,000 divided by 12), sending it over to the Income Statement on a monthly basis to be shown as an expense for that month. *Warranty uplifts* and *warranty extensions* are handled just the same way.

Capitalizing Hardware and Software

It's a different story when accounting looks at the software and hardware purchases. Both will provide benefit over many months, sometimes years. How long? Operational management must make this decision with guidance from accounting. Over what timeline does the payment benefit the business? If the expenditure benefits many months or years, accounting will *capitalize* these expenditures.

Let's, for example, look at the purchase of the *hardware* totaling $360,000 and assume that the equipment will last for 4 years before wearing out or becoming obsolete. The day accounting pays the check for this hardware, the total $360,000 is first loaded on the company Balance Sheet. The next step involves the concept of depreciation. Since the hardware is expected to last 4 years, the total value of the hardware shown on the Balance Sheet will be depreciated (i.e. expensed) on a monthly basis at the rate of $7,500 per month ($360,000 divided by 48 months). When you're preparing your *operating budget* for your business case, hardware depreciation for the pilot program expense is $7,500 per month – instead of the initial cash outlay of $360,000. This means the cost of the equipment is spread out over 4 years making it easier to cover the expense with estimated future earnings. Notice the other beauty of this concept. The cost of the equipment is matched up on a monthly basis with the revenues these devices are "helping to drive".

The $300,000 investment in *software* is treated the same way. How long will the software be "useful" for the company? Making this determination when it comes to software is much trickier. Management will need to take into consideration factors internal and external to the company, including whether the software might become obsolete, whether new technologies might replace this software solution, and whether planned upgrades of operating systems or software applications might impact the useful life of the investment. Once the useful life has been determined, the purchase price is capitalized (i.e. placed on the Balance Sheet) as an asset and then amortized (i.e. expensed) over the "useful life" of the software.

Conclusion: It's a New World

The rules relating to capitalization can be very complex, especially for intangible assets such as software. A core distinction is made between technology developed for internal use versus technology developed for sale to customers. For this column, we're focusing on *software developed for internal use*. In the good old days, companies would bundle together software, hardware, related consulting and implementation fees and treat this as "one" total investment or asset. If the hardware was anticipated to have a useful life of 5 years, then all of the associated expenditures would also be depreciated over 5 years, even though all of the implementation and training was in year 1. In our example, monthly depreciation would have been $13,750 under the bundled method, versus $20,000 a month if the hardware and software were separately depreciated. This assumes hardware is depreciated over 4 years, software over 2 years.

But, this no longer works, even when the vendor prices everything as one bundled number. The new rules require that companies allocate specific cost to hardware, software, implementation, services, and training fees. If training is bundled into the price, the company must determine the separate cost of training and then expense this amount as training sessions are actually used. These rules have effectively reduced the ability to "manage the numbers" for an area that represents a very significant dollar impact on the financials. And, for the sales team this means that the old tactic of selling training, maintenance and other services up front so that these can be included in the capital budget is no longer a "deal maker".

About the Author

Gudrun Granholm is the CEO and Founder of Box One, Inc., a firm specializing in custom financial training, financial skill assessment and related financial consulting for "operational" professionals, managers and executives. Gudrun has devoted her career to helping managers quickly understand the financials from a strategic perspective. The training and consulting connects manager's decisions and actions with their impact on the financials and develops a "total company view". It allows communication across all levels of the organization through the use of a shared financial language using the Box One Model™ in order to drive optimal financial performance. Prior to founding Box One, Gudrun served in a variety of financial roles, from financial analyst, controller to CFO/CEO over a 25 year period, including The Washington Post Company and The Smithsonian. Her training and consulting includes engagements with Fortune 500 organizations, universities and associations. Gudrun received her BA from Harvard University and her MBA from Stanford University Business School. For more information you can reach Gudrun at:

Box One, Inc.
15455 NW Greenbrier Parkway
Suite 250
Beaverton, OR 97006
503.352.0850 x111
gudrung@BoxOneLeader.com
www.BoxOneLeader.com

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