Allocating for Capital Projects

How much money should the budget manager allocate to each capital expenditure each month? In the case of the equipment and depreciation, the budget manager would use the company’s standard techniques for calculating depreciation and allocate the appropriate amount every month. The same concept applies to other capital expenditures as well. The budget manager would properly divide the amount of money needed each month for each employee. Generating the planned amount required for each capital expenditure in this way is not too difficult.

But what happens when things change halfway through the year, based on events that the plan did not account for? For example, a technology firm could purchase a new machine or have a new machine built for it to build the next generation of computers. But what happens if that machine unexpectedly breaks down, and there is no warranty? The company is now in a tricky situation. The machine is required because the company has already begun production on the new product. As a result, abandoning the creation of the new computer is not a good choice for the firm. The company could, on the other hand, refurbish the machine, which is to spend more money on the machine to have it fixed, or it could attempt to build the new generation of computers on a different machine. The budget manager now has a dilemma: money spent on refurbishing the machine is not budgeted or allocated, and stopping production on another line means that those products will not be produced, leading to a loss of profitability for the company.

Budgeting in times of uncertainty can be very challenging. What should the budget manager have done before this happened? The budget manager could have developed several different scenarios based on previous experience of what could happen to the machine. The budget manager could generate a best-case scenario (the scenario in which the budget meets the planned expenses), a worst-case scenario (the scenario in which everything begins to fall apart), and finally a reasonable scenario (the scenario in which some things do not go as planned, but not everything falls apart). The budget manager could place a probability on each of these scenarios. The probabilities could then be used as weights, and the budget manager could generate a weighted average of the three scenarios. The weighted average would then be used as the amount of resources to be used to plan the budget allocations.
Allocating for Capital Projects

If a technology firm planned on hiring a person with a salary of $50,000, the best-case scenario would be a budget of $10,416.67 every month. This value was calculated as \( \frac{50,000 \times 2.5}{12} = 10,416.67 \). What if the person required a higher salary than $50,000? The worst-case scenario, the price the firm will not exceed might be $75,000. The monthly cost of a person making $75,000 would be $15,625.00. This value was calculated as \( \frac{75,000 \times 2.5}{12} = 15,625.00 \). The firm feels that the person will most likely have a salary of $60,000. The monthly cost of a person making $60,000 would be $12,500.00. Again, this value was calculated as \( \frac{60,000 \times 2.5}{12} = 12,500.00 \). The budget manager might put a 25% likelihood of the hired person receiving $50,000 a year, a 50% likelihood of the hired person receiving $60,000, and a 25% likelihood that the hired person will receive $75,000 a year. Based on the probabilities, the estimated salary is $61,250. This value was generated as follows: \( \frac{(50,000 \times 0.25) + (60,000 \times 0.50) + (75,000 \times 0.25)}{3} = 61,250 \). The salary of $61,250 will give a monthly cost of $12,760.42. This is one of several different techniques the budget manager can use to generate a conservative budget for the company. Companies use different techniques because of their experiences and their field because capital budgeting in uncertainty is difficult.