5 Critical Items Never to be Included in Cost Benefit Analysis

When dealing with decisions using Cost Benefit Analysis techniques it is very important to follow the proven principles. The health of your company and your reputation depend on it. If these rules are not followed then your decisions could be flawed.

Let's start, shall we?

Critical Item #1. Sunk Costs

Irrecoverable cash outlays that occurred prior to the evaluation of the project are excluded, only the present and future costs/benefits are assessed. You cannot go back in time to add in past costs, only deal in the current and the future, as best you can.

Critical Item #2. Arbitrary Accounting Cost/Income Allocations

Depreciation - Depreciation is not a cash item. It relates to cash expended on capital purchases in previous periods. It is intended to show the decreasing value of the asset as time passes and as the asset ages through use or obsolescence.

To include depreciation in Cost Benefit Analysis, would be to double-count the expenditure. The decreasing value of the asset is shown by the difference in the purchase price and the eventual disposal or sales price at the end of its life.

Accruals - Accruals are an accounting method of moving costs and income to different years as compared to when the transaction actually occurred. In Cost Benefit Analysis, we are dealing only in cash transactions in the year they occurred. Accruals have no role here.

Critical Item #3. Price Changes Due to Inflation

The Discount Rate used in the model is designed to take account of inflation during the life of the project. The Discount Rate reduces the value of the costs and benefits as time progresses, just as inflation does. If inflation-based price changes were included in the analysis, then they would be double-counted.

Critical Item #4. Book Gains or Losses

Accountants use this method to take account of the fact that the value of the asset at time of disposal is not equal to the depreciated value in the company's books. This often happens, since it is not always possible to accurately predict the selling price or disposal value at the time of purchase when the life of the asset is longer than a year or two.

However, in Cost Benefit Analysis models the purchase price and the selling price are always clearly stated, so there is no need to adjust.

Critical Item #5. Loan Repayments

The use of the Discount Rate is designed to take account of the cost of financing the project whether in terms of interest rate (if the funds are borrowed) or return on equity (if the funds are provided by shareholders). The actual cash repayments on the loan have no place in this analysis. Neither does the interest component of the repayments.

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About the Author

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