

Do You Make These 10 Mistakes With Cost Benefit Analysis?

Now let's dive right in and list them out shall we?

Mistake #1: Not thinking widely enough to explore all feasible options.

First, a note about benefits - if you can provide a solution that provides more benefits than the current process, then not only do you benefit (hopefully in practical and emotional ways) but also the company profits, so do the shareholders and so does the economy. If more of these positive benefit decisions were being made daily by more and more people then we would all be better off!

It is human nature to want to think about the problem quickly, get to an answer (instead of a list of good answers) as soon as possible and move on.

This is the MAIN mistake that needs to be addressed before launching into the rest of the mistakes.

For Example: If a decision is to be made regarding the company's business systems, close study would need to be given to ensure all feasible software providers were involved. Not only would you need to look at software providers but also hardware sources and bureau services. Also, will the future direction of the business mean that simply replacing "like with like" be suitable? Also is the "do nothing" option viable?

Mistake #2: Not using "Cradle to Grave" timeframe.

As the term implies, all costs and benefits associated with the project from the time the analysis begins ("birth") to the sale ("death") of the asset must be included. If this process is neglected, costs such as sale of assets and/or disposal of assets, site cleanup and site re-instatement may be omitted from the calculations that could provide an erroneous result (and maybe embarrassment to you as the project champion). In addition, this provides for all "birth" costs, such as new asset purchase costs, transport costs, site preparation costs and the sale of the old asset to be included in calculations. Don't neglect these - they can make a huge difference to the outcome.

Mistake #3: Not using Net Present Value to take account of the Time Value of Money.

Typically the life of the assets, or the decision being made, have an impact over more than 1 year. This is usually 3 - 5 years (computers, software, factory machinery), 20 years for some large electrical equipment and even up to 100 years for underground pipes as used in water and sewer reticulation.

As you would know, and as Howard Hughes said in 1937, "A million dollars is not what it used to be". This is because inflation, year by year, reduces the buying power of the dollar causing us to spend more each year to purchase the same item. So it is with projects whose life span is more than one year.

(Let's say, that the interest rate is 5%, you would only need to deposit about \$95 today to get \$100 next year. Economists would say that, at a 5% discount rate, \$100 next year has a present value of \$95.) For longer periods of time, and/or higher discount rates, the effect is magnified.

Costs and benefits that occur in year 3 or 4 of the project would not have the same impact as if they occurred in year 1. There is a function within Excel that accounts for this so there is no real need to concern yourself with it too much here.

Suffice to say that transactions further into the future have less of a dollar impact than the current transactions. This must be included in your calculations.

Mistake #4: Including other than CASH transactions in the Costs and Benefits calculations.

Some practitioners use accounting terminologies such as Depreciation, Accruals or Deferrals in their Cost Benefit models. This is not correct. We are only dealing with the cash costs and benefits. This keeps the model:

- Easy to understand for non-accountants
- Free from any artificial spreading of costs and income that are not really related to the period

It is important that the cash flow of costs and benefits are shown in the years they actually occur - since moving them into other years can increase or decrease their value due to the time value of money as discussed above. (A cash transaction occurs when there is a monetary transaction - either outflow or receipt.)

Mistake #5: Not considering the "Do Nothing" option.

Just because an asset is ageing or in need of repair, it does NOT necessarily mean that a replacement is the best use of the available resources. It could well be that this option continues to be the most feasible option. This option should always be considered and accounted for when thinking of ALL feasible options.

Mistake #6: Forgetting to include non-financial Costs and Benefits.

There are many benefits and costs that can be part of the decision process, which really do not have hard quantifiable values. Some of these could be:

- The cost of a human life (e.g. saved by installing traffic lights a school crossing)
- Damming of a river and the loss of habitat of many flora and fauna species
- Extra noise created as a result of road relocation
- Increasing obesity of school children and poor health outcomes

Another example of non-financial costs and benefits could be political affiliations/expediency that could sway a decision even though the Cost Benefit model shows this to be a less beneficial option than other options.

Mistake #7: Thinking that Cost Benefit Analysis is THE solution to the problem.

Cost Benefit Analysis and NPV are tools or techniques that assist in the decision or judgement. These processes are not an end in themselves. They are part of a suite of tools that /engineers/accountants/managers/business owners can call upon to assist in the making the final decision.

Mistake #8: Adding in Sunk Costs on the projects prior to the Cost Benefit Analysis being undertaken.

Costs that have been expended are NOT to be included since these have been made outside the view of your analysis. You cannot go back in time to add in past costs, only deal in the current and the future, as best you can.

Mistake #9: Not delivering on savings promised in the Cost Benefit Analysis proposal.

I have seen many Cost Benefit Analyses where the purchase of new computers or machinery has relied on (at least to some extent) the savings in labour. This is all well and good.

The project champion has ensured that ALL the labour costs were included (eg annual leave, superannuation, health care costs, public holidays and other loadings) but once the project had received the go-ahead he/she has omitted to make the labour savings by making the labour redundant or finding these employees gainful employment in other parts of the organization.

Another example is when machine hours have projected savings shown in the Cost Benefit Analysis model but due to internal politics the changes to operating procedures were not implemented once the project was implemented.

You will notice when building a Cost Benefit model that the Costs are reasonably easy to calculate since most of them have quoted prices or contracts etc. on which to rely. It is the Benefits that will cause most discussion and these need to be tied down tightly prior to the go-ahead being given.

It is really important to be certain of all your assumptions so that you can confidently argue the merits (and drawbacks) of the project.

Mistake #10: Not performing a Project Completion Review during the life of the project once it is implemented.

Unless this step is taken any lessons to be learned either by you or the organization are lost. Yes, it may cause some embarrassment if not all the

benefits were not realised and some costs came in at more than planned. But that is not as important as repeating these "sins" again and again on subsequent projects. Make this part of the corporate culture and you will notice an improvement over time to your benefit and the benefit of the company and the economy.

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