

Cost-Benefit Analysis

Limitations of Cost-Benefit Analysis

For projects that involve small- to mid-level capital expenditures and are short to intermediate in terms of time to completion, an in-depth cost-benefit analysis may be sufficient enough to make a well-informed, rational decision. For very large projects with a long-term time horizon, a cost-benefit analysis might fail to account for important financial concerns such as inflation, interest rates, varying cash flows, and the present value of money.

Alternative capital budgeting analysis methods, including net present value, could be more appropriate for these situations. The concept of present value states that an amount of money or cash in the present day is worth more than receiving the amount in the future since today's money could be invested and earn income.

One of the benefits of using net present value for deciding on a project is that it uses an alternative rate of return that could be earned if the project had never been done. That return is discounted from the

results. In other words, the project needs to earn at least more than the rate of return that could be earned elsewhere or the [discount rate](#).

However, with any type of model used in performing a cost-benefit analysis, there are a significant amount of forecasts built into the models. The forecasts used in any CBA might include future revenue or sales, alternative rates of return, expected costs, and expected future cash flows. If one or two of the forecasts are off, the CBA results would likely be thrown into question, thus highlighting the limitations in performing a cost-benefit analysis.