Relevant Project Cash Flows

Only Incremental Cash Flows (total cash flows with the project minus total cash flows without the project*) are relevant.

*Presumes all alternatives are being considered, including abandoning unprofitable activity.
Some special cases:

– Sunk costs; not relevant because they are not incremental

– Allocated overhead; only incremental overhead is relevant

– Value of owned resources; sunk cost versus opportunity cost

– Recovery of net working capital

– Complimentarity and substitutability in other project cash flows

– Excess capacity; is it really excess?
Example: Classic Video Rentals is considering opening a new retail outlet in a newly developed section of Atlanta. In late 2000, Classic had purchased a piece of land in this section that is suitable for its outlet.

It paid $530,000 for the land at that time. Should the land cost be charged to the new retail outlet? Since Classic
already owns the land, isn’t this resource free to the project?

Due to significant development, the land is currently worth $655,000.

The new retail outlet will increase Classic’s overhead by $4,000 per year and accountants have allocated $12,000 of existing overhead to the new outlet. Thus overhead expenses for the new
outlet will be $16,000 per year. Should this be charged to the new outlet?

Classic estimates that total sales for the new outlet will be $170,000 per year. Should this amount be used in figuring the cash flows for the new outlet?

The accounting for the new outlet’s inventory, wages and salary, and other
record keeping can be handled with no incremental outlays because Classic installed last year an accounting and information system that has excess capacity.