# Teach Yourself: Economic Evaluation:

1p: Sunk Costs

### The purpose of this module is to ...

Level 3: Decision making

Level 2: Evaluat

discuss how sunk costs are treated in evaluation models

Level 1: Hands-on economic modelling

## Are **sunk costs** included in an evaluation? Is cash spent in the past included?

The usual answer is "No!" because only costs from now on are included. Frequently it is said "The valuation does not consider how much money has been sunk into the business/ project in the past – it only worries about cash flows in the future."

"I understand you have invested \$10 million in setting up your business, but looking forward it is expected to generate cash flows with a net present value of only \$6 million, so that is what I think it is worth!" Are sunk costs included in an evaluation? Is cash spent in the past included?

But the proper answer is "Yes!" "because when I compute the value of a business I include the benefit in future tax computations of any cash invested in the past which has not yet been claimed." So the full explanation becomes: -

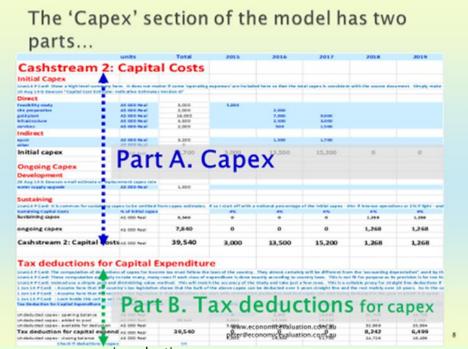
"I understand you have invested \$10 million in setting up your business, and I have included future tax deductions of \$10 million \* 25% income tax rate = \$2.5 million, but even after including this benefit when I look forward it is expected to generate cash flows with a net present value of only \$6 million, so that is what I think it is worth!"

# Back in the Hands-On-Modelling modules you should have worked through the following slides →

#### Teach Yourself Economic Evaluation

### 1j. Hands On Modelling Tax deductions for capex

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### Part A generates: 'Cashstream 2: Capex'

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### Part B generates: Its deductions for income tax

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In that example the opening balance of unclaimed deductions was zero.

	units	Total	2015	2016	2017	2018	2019
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Cashstream 2: Capital Cost	15 44 000 test	39,540	3,0	13,500	15,200	1,268	1,268
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	AS 000 New!		3.600 nor an	onomit Waluati	uRSébound	92,968	25,994
Tax deduction for capital		39,540				8,242	6.499

For my present example where \$10 million has been spent by the present owner, I would go to my tax specialist or accountant and discuss which parts, could we deduct from future assessable income if we purchased the business.

After examining the detail, this specialist might tell me that:

- \$2.2 million has already been claimed by the present owner,
- \$1.3 million is not a legitimate deduction for <u>us</u>, so that <u>our</u> opening balance of unclaimed deductions for capex would be \$6.5 million.

We would then discuss the mechanics of how each category of past expenditure could be claimed by our company.

I would aim to get the OK to:

- pool it with all future capex (in one or two pools) and
- deduct the aggregate on a diminishing value basis (at 150% or 200% of straight line rate) because this so much simpler than matrices of straight line deductions. The difference is likely to have minimal impact on NPV; as discussed elsewhere.

(Remember you can spend the rest of your life doing highly accurate income tax computations as though you were completing the Company's income tax return - or you can get a fit-for-purpose result in just a few rows, with the same impact on NPV, by using diminishing value pools.

People with commercial backgrounds are infamous for highly detailed tax computations but coarse computations, where it really matters, in production.)

## Any opening balance of unclaimed deductions for past capex could go in here (Such as our §6.5 million)

	units	Total	2015	2016	2017	2018	2019
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### Do a spot check that:

- your total deductions over the business life = unclaimed opening balance + future capex
   the resulting tax benefit makes sense.
- Be alert for:
- some countries have limits on how many years these unclaimed amounts can be carried forward.
- Some deductions are not transferable to new owners.
- People talk about 'unclaimed deductions' and 'tax losses' as if they are the same. To me the 'tax loss' here would be 25% (income tax rate) of the 'unclaimed deduction' so probe for exact details.
- Do not go alone but ask your tax experts and get it right!

Unclaimed deductions, and how they can be claimed by new owners, are very important when purchasing an existing business or an unfinished project.

End