

Making sense of investment appraisals

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Background

A few years ago I was working for an insurance broking group as a project manager in their Information Systems Development Team.

The company had a systems development methodology, which included project management processes, and most projects followed the methodology quite closely

The standard practice in the department was for a feasibility study to be undertaken before any project could start, and a small group of specialist business analysts carried out these studies.

The feasibility study reports were presented to the strategy board and, if approved, passed to project managers such as myself for implementation.

Objective

Unfortunately, the project teams had a poor reputation for delivery to budget. Timescales and functionality targets were usually achieved well enough, but almost every project overran the development cost budget created in the feasibility study. Senior management were not pleased with this situation, as it upset their attempts to manage the finances of the organisation.

The story unfolds...

Consultants were called in to fix the problem, and they immediately started on an exercise to monitor the cost control methods used by the development project teams. However, it quickly emerged that the original estimates in the feasibility study were usually to blame. They were too optimistic, and, in some cases, completely unrealistic. The terms of reference of the consultants were widened to include a study of the business analysts, and how they arrived at the cost estimates in their feasibility studies.

The business analysts were using company rules provided by the Chief Accountant (rates of return, discount rates, labour costs and so on). The rules also said that each of the options (there were usually 3 or 4 options proposed in each feasibility study, with one of them being the recommended solution) should have a full cost/benefit analysis, based on returns over 5 years.

Once the board approved a recommendation, the project was started using as a budget the cost figures from the feasibility study.

Well, it seemed obvious to investigate the way the estimates for development costs were established, and this was duly done. The business analysts were challenged quite aggressively about exactly how they arrived at the estimates, but much to everyone's confusion, the estimating methods and approaches were impeccable. Actual figures from previous similar projects were compared with suggestions of development approaches for the project in question; experienced technical people from the development teams were invited to comment; manufacturers' manuals, user groups and other forums were consulted where appropriate prototypes were built. It was classic textbook estimating, and could not be faulted.

Nevertheless, the cost figures quoted in the cost/benefit analysis were almost always far adrift from reality (thank goodness we didn't do much benefits management in those days - who knows what we would have found out about them).

Then the company accounting rules were scrutinised, and with a bit of pushing, the penny dropped (no pun intended).

The company financial guidelines spelt out quite clearly that cost/benefit analyses (CBA) were to be completed to enable senior management to compare the payback profiles of a range of options in order to select the 'best' one. This guideline allowed comparison across options in a single feasibility study and across a range of feasibility studies, to make sure that the company's financial resources were deployed in the most effective manner.

Because options may have widely different cost and benefit profiles, certain baselines and ground rules had to be applied to allow like-for-like comparison.

For example, all costs had to be established at a given date in time, and these costs were to be used for all five years in the CBA table. Standard personnel cost rates were to be used, and there was to be no allowance for inflation, pay rises, decreasing hardware costs, capital allowances on acquisitions, tax or depreciation.

The last few factors had little impact on the actual development costs, but the use of standard labour rates with no allowance for inflation and pay rises rang warning bells straight away. Of course this strategy was fine for making financial comparisons, but the figures obtained made no sense at all when used as the basis of the development budget. It was immediately clear where the so-called project budget overruns were coming from!

The solution was not so obvious, and was the subject of some debate between the accountants on the one hand (the defenders of the method) and the business analysts and development project teams on the other (the folks who had been taking a lot of criticism over the years).

The accountants won the day. They wanted to stay with the current method of presenting CBAs, as it made for easy comparison and decision-making. They suggested that the project teams should produce a new, more realistic project cost plan once the strategy board had approved the feasibility study. The project teams went along with this proposal, as it gave them an opportunity to re-estimate the costs on a more realistic basis.

This whole process was watched with trepidation by the senior management, who were faced with the prospect of having projects apparently costing more than before. Of course, we tried to tell them that all we wanted to change was the estimated cost; the actual costs had always overrun, and now the estimates would be more accurate. Unfortunately, this meant bad news (i.e. higher costs) up front, and was a bitter pill for the board to swallow.

Eventually the project board accepted the approach; the business analysts completed the CBA using 'false' figures, so that like-for-like comparisons could be made, and the project teams re-estimated the project to give a more realistic project budget. The project board got used to looking at two different sets of numbers, and making decisions based on each. It seemed like a lot of extra work, but it gave everyone the chance to contribute with their own skills and experience, and the project budget overruns decreased in number (but I'm not going to tell you by how much!).

Moral

The point I drew from this was to make sure that I understood the use to which a feasibility study was going to be put, and the basis upon which decisions were going to be made. Both approaches outlined above have their drawbacks, but as long as all parties to the process understand how the figures are derived, and whether the figures are either 'real' or 'for comparison only', then the

system works. Yes, it is messy, but on a long project or programme, stretching over several financial years, the alternatives are even messier.