

## Cost Benefit Analysis How It Helps You Make Better Financial Decisions 9 Ways

Good financial decisions are the life-blood of a vibrant business. The 9 ways listed below will help you to improve the way you make financial decisions, guaranteed. Let's list them out shall we?

### 1. Forces more options

It is pointless doing this analysis if you do not investigate ALL the available options. More options will mean a better outcome. What is the use of just hoping that your decision is best if you haven't spent the time to ensure you have canvassed ALL the feasible ways of solving your problem?

Maybe the 'Do Nothing' option is the best way. Unless you test it out you won't know.

There are resources to assist in thinking more creatively thereby allowing you to generate more ideas and options. Search the Internet under "creative thinking", you will find many to choose from.

Thinking through all the options lays a good foundation for the analysis that follows.

### 2. Puts \$s to costs and benefits

Placing a \$ figure against all the costs and benefits provides a standardized way of looking at the answer. The answer is termed the Benefit Cost Ratio. There are certain costs and benefits that must be included and there are some that must be excluded.

Follow the proven guidelines and you can't go wrong.

Some costs and benefits that must be included are:

- purchase price
- set up costs
- on-going maintenance costs
- resale price
- savings in labor, input resources, increased safety,

Some costs and benefits that must be excluded are:

- sunk costs
- depreciation and other accounting arbitrary allocations
- loan interest and repayments
- price changes due to inflation

This method provides a clear analysis of the option so that the best option stands out.

### 3. Takes account of inflation/time value of money

Typically the life of the assets or the decisions 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, 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. 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. Agreed?

This is a very important aspect of Cost Benefit Analysis-one you cannot discard. If you want to make the best decision this needs to be taken into account.

Cost Benefit Analysis models clearly outline the assumptions, the costs, benefits and the method of adjusting for changes in purchasing power over

time.

#### 4. Cradle to Grave view of assets

When making decisions regarding asset purchases it is critical that ALL the costs relating to the asset are included in the proposal. How can you make a valid comparison between competing proposals unless all the costs are thought through and included?

Some costs that are commonly missed are:

- installation costs
- initial transport costs
- tender preparation costs
- de-commissioning of old plant
- de-commissioning of this plant at the end of its life
- extra administrative effort
- labor on-costs

#### 5. Clearly shows assumptions

Cost Benefit Analysis offers the ability to clearly outline all assumptions and how they were arrived at. This is especially important when discussing the merits, or otherwise, of each competing proposal. It also provides a firm foundation for discussing the lessons learnt once the successful proposal has been implemented.

#### 6. Clearly shows which projects are VIABLE and which are UNVIABLE

The Cost Benefit Analysis model clearly shows which option is worthwhile adopting and which is not. If the Benefit Cost Ratio is 1 or greater, that project is viable, less than 1 means it is unviable (all other things being equal). Once this has been calculated for all competing feasible options you can then choose the option with the highest Benefit Cost Ratio from those that are classed as viable.

The option with the highest Benefit Cost Ratio will also add the most shareholder value as well.

#### 7. Provides basis for sensitivity analysis

No doubt, when you build your assumptions some elements are more sensitive to change and produce a greater impact on the overall result than others. The process to test these elements is called Sensitivity Analysis. Since the assumptions are clearly laid out, it is usually quite easy to create a Sensitivity Table. This can add a lot of weight to your proposal.

#### 8. Makes post completion review a breeze

Once the correct option has been chosen, funded and implemented and has been operating for about a year it is a good time to go back and assess the quality of your original assumptions. You can check on the cost and benefits elements-compare assumed prices with actual. and see how close they were.

What lessons can be learned here? Mostly costs are underestimated and benefits overestimated. Were there any mistakes made?

This analysis can help you ensure that any mistakes made are not transferred to the next project.

#### 9. Proven framework makes selling easier

If you need to 'sell' your project to various stakeholders, be they employees, shareholders, the press, unions, politicians or the Board of Directors, the fact that you have used the proven, tested process will make the selling easier.

These are just a few of the ways Cost Benefit Analysis can help you make better decisions.

Source: <http://www.articlecircle.com>

### About the Author

Bruce Hokin is an experienced accountant (FCPA). His main interests are in better decision-making and Cost Benefit Analysis training. You can find more of his in-depth FREE articles, a FREE Newsletter and FREE e-zines at his website. To sign up for his comprehensive, downloadable Cost Benefit Analysis training program "5 Steps to Cost Benefit Mastery" just go to his website. You could be using this technique in under 2 hours! Available at [www.thecostbenefitcoach.com](http://www.thecostbenefitcoach.com)