ESTIMATES OF FINANCIAL COSTS AND BENEFITS OF THE BUSINESS OUTCOMES.

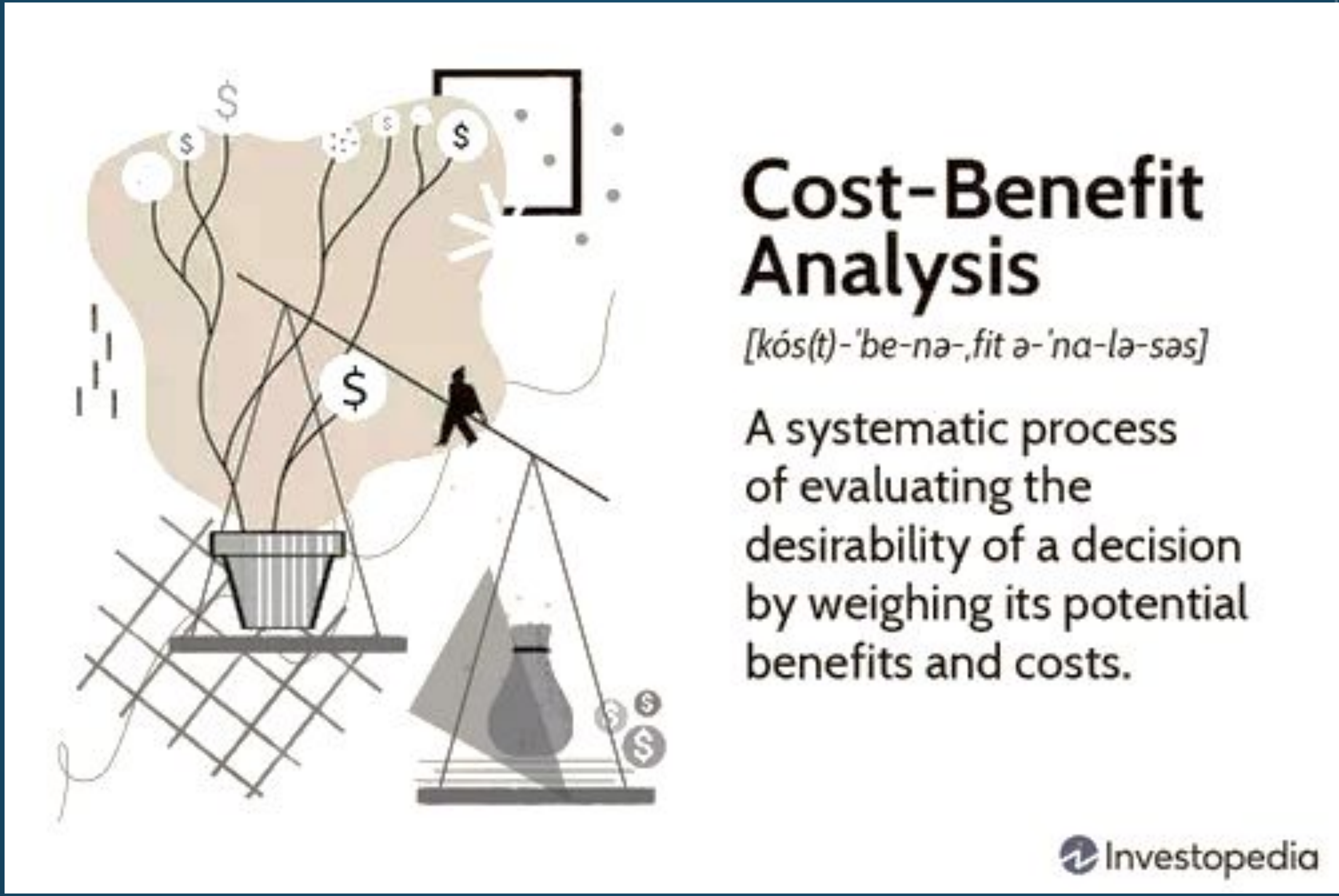
LECTURE – 28 AND 29

20MS2007 - BUSINESS PLAN

WHAT ARE FINANCIAL COSTS AND BENEFITS?

- ✔ A cost-benefit analysis is the process used to measure the benefits of a decision or taking action minus the costs associated with taking that action.
- ✔ A cost-benefit analysis involves measurable financial metrics such as revenue earned or costs saved as a result of the decision to pursue a project.

IN OTHER WORDS



EXAMPLE

- Building a new product will cost 100,000 with expected sales of 100,000 per unit (unit price = 2).
- The sales of benefits, therefore, are 200,000.
- The simple calculation for Cost Benefit Analysis for this project is 200,000 monetary benefit minus 100,000 cost equals a net benefit of 100,000.

WHY COST-BENEFIT ANALYSIS?

- A cost-benefit analysis is a systematic process that businesses use to analyze which decisions to make and which to forgo.
- **The cost-benefit analyst sums the potential rewards expected from a situation or action and then subtracts the total costs associated with taking that action.**

COST-BENEFIT ANALYSIS – HOW IT IS DONE?

1. Identify Project Scope
2. Determine the Costs
3. Determine the Benefits
4. Compute Analysis Calculations
5. Make Recommendation and Implement

1. IDENTIFY PROJECT SCOPE

- The first step of a cost-benefit analysis is to understand your situation, identify your goals, and create a framework to mold your scope. The project scope is kicked off by identifying the purpose of the cost-benefit analysis.
- **An example** of a cost-benefit analysis purpose could be "to determine whether to expand to increase market share" or "to decide whether to renovate a company's website".
- This initial stage is where the project planning takes place, including the timeline, resources needed, constraints, personnel required, or evaluation techniques. It is at this point that a company should assess whether it is equipped to perform the analysis. For example, a company may not have the technical staff required to perform an adequate analysis.
- During the project scope development phase, key *stakeholders* should be identified, notified, and given a chance to provide their input along the process. It may be wise to include those most impacted by the outcome of the analysis depending on the findings (i.e. if the outcome is to renovate a company's website, IT may be required to hire multiple additional staff and should be consulted).

2. DETERMINE THE COSTS

- **Direct costs** would be direct labor involved in manufacturing, inventory, raw materials, and manufacturing expenses.
- **Indirect costs** might include electricity, overhead costs from management, rent, and utilities.
- Intangible costs of a decision, such as an impact on customers, employees, or delivery times.
- **Opportunity costs** such as alternative investments, or buying a plant versus building one.
- **Cost of potential risks** such as *regulatory risks*, competition, and environmental impacts.
- When determining costs, it's important to consider whether the expenses are reoccurring or a one-time cost. It's also important to evaluate whether costs are variable or fixed; if they are fixed, consider what step costs and relevant range will impact those costs.

3. DETERMINE THE BENEFITS

Every project will have different underlying principles; **benefits might include the following**:

- **Higher revenue and sales** from increased production or new product.
- **Intangible benefits**, such as improved employee safety and morale, as well as customer satisfaction due to enhanced product offerings or faster delivery.
- **Competitive advantage** or market share gained as a result of the decision.

4. COMPUTE ANALYSIS CALCULATIONS

Some cost-benefit analysis require more in-depth *critiquing*. This may include:

- Applying discount rates to determine the net present value of cash flows.
- Utilizing various discount rates depending on various situations.
- Calculating cost-benefit analysis for multiple options. Each option may have a different cost and different benefit.
- Level-setting different options by calculating the cost-benefit ratio.
- **Performing sensitivity analysis to understand how slight changes in estimates may impact outcomes.**

5. MAKE RECOMMENDATIONS AND IMPLEMENT

- The analyst that performs the cost-benefit analysis must often then synthesize findings to present to management.
  - This includes concisely summarizing the costs, benefits, net impact, and how the finding ultimately supports the original purpose of the analysis.
- **Broadly speaking, if a cost-benefit analysis is positive, the project has more benefits than costs**. A company must be mindful of limited resources that might result in mutually-exclusive decisions.
- For example, a company may have a limited amount of capital to invest; although a cost-benefit analysis of an upgrade to its warehouse, website, and equipment are all positive, the company may not have enough money for all three.

ESTIMATING YOUR COSTS

Direct Costs

Help You Produce Your Goods or Services

The physical materials needed to make your product.

The servers needed to power your ecommerce site.

The salaries and commission you pay employees to produce and sell your product.

Transportation methods that get your product to the consumer.

Indirect Costs

Help You Support Your Business in Other Ways

The rent prices and fees that come with facilitating an office.

Expenses needed to keep your team happy and motivated (e.g. office perks or team lunches).

Supplies needed to help your office run smoothly.

Technology and IT that doesn't directly help produce products.

DIRECT COSTS

- **Direct Costs** are generally straight forward to identify as they relate specifically to a product: e.g. labour, material and shipping costs.

INDIRECT COSTS

- **Indirect costs,** for example, rent and service charges, will need to be included in the general overheads and a proportion of those general overheads will need to be added to the cost of each product to arrive at its **true cost**.
- The principle is that overheads also need to be covered and therefore "**the overhead recoupment cost**" is an important financial that needs to be kept up to date to make sure that your sales prices cover all the costs of running the business.

Direct Cost VS Indirect Cost

#1. Meaning

Direct Cost	Indirect Cost
These are the costs that can be easily identified as per the cost objects.	These are the costs that aren't easy to identify as per the cost objects.

#2. Expended on

Direct Cost	Indirect Cost
Particular cost objects.	Multiple cost objects.

#3. Can be identified as

Direct Cost	Indirect Cost
It can also be called as variable	It can also be called as fixed

#4. Place in the cost sheet

Direct Cost	Indirect Cost
It is computed at the beginning of the cost sheet.	It is ascertained after computing the direct costs.

#5. Aggregate in the cost sheet

Direct Cost	Indirect Cost
An aggregate of direct costs in the cost sheet is called prime cost.	The aggregate of indirect costs in the cost sheet is called overhead cost.

#6. Can it be attributable?

Direct Cost	Indirect Cost
Yes.	No.

#7. Example

Direct Cost	Indirect Cost
An example of this cost is the cost attributable to direct material, direct labor, and direct wages.	Example of this cost is rent, advertisement, etc.

OTHER COSTS

- **Intangible costs:**
  - These are any current and future costs that are difficult to measure and quantify. Examples may include decreases in productivity levels while a new business process is rolled out, or reduced customer satisfaction after a change in customer service processes that leads to fewer repeat buys.
- **Opportunity costs:**
  - This refers to lost benefits, or opportunities, that arise when a business pursues one product or strategy over another.

ADVANTAGES OF COST-BENEFIT ANALYSIS

- ✔ **A Data-Driven Approach**
  - ✔ Cost-benefit analysis allows an individual or organization to evaluate a decision or potential project free of biases. As such, it offers an agnostic and evidence-based evaluation of your options, which can help your business become more data-driven and logical.
- ✔ **Makes Decisions Simpler**
  - ✔ Business decisions are often complex by nature. By reducing a decision to costs versus benefits, the cost-benefit analysis can make this dilemma less complex.
- ✔ **Uncovers Hidden Costs and Benefits**
  - ✔ Cost-benefit analysis forces you to outline every potential cost and benefit associated with a project, which can uncover less-than-obvious factors like indirect or intangible costs.

LIMITATIONS OF COST-BENEFIT ANALYSIS

- **Difficult to Predict All Variables**
  - While cost-benefit analysis can help you outline the projected costs and benefits associated with a business decision, it's challenging to predict all the factors that may impact the outcome. Changes in market demand, material costs, and the global business environment are unpredictable—especially in the long term.
- **Incorrect Data Can Skew Results**
  - If you're relying on incomplete or inaccurate data to finish your cost-benefit analysis, the results of the analysis will follow suit.
- **Better Suited to Short- and Mid-Length Projects**
  - For projects or business decisions that involve longer timeframes, cost-benefit analysis has a greater potential of missing the mark for several reasons. For one, it's typically more difficult to make accurate predictions the further into the future you go. It's also possible that long-term forecasts won't accurately account for variables such as inflation, which can impact the overall accuracy of the analysis.
- **Removes the Human Element**
  - While a desire to make a profit drives most companies, there are other, non-monetary reasons an organization might decide to pursue a project or decision. In these cases, it can be difficult to reconcile moral or "human" perspectives with the business case.

SUMMARY

- What are the financial costs and benefits?
- Example.
- Why Cost-Benefit Analysis?
- Limitations of Cost-Benefit Analysis.
- Different costs.
- Cost-Benefit Analysis – How it is done?