Use Cost/Benefit Analysis for Decision Making

A cost/benefit analysis (sometimes referred to as 'CBA') is a management tool that will give you an idea of whether a possible course of action will yield positive or negative results. It does this by adding up the positive aspects of the action, and then subtracting the negative aspects from the positives. If the outcome is a negative number it's an indication that the action will yield negative results and shouldn't be carried out.

Different types of costs and benefits

The various types of costs and benefits need to be taken into consideration. Both can be either one-off or ongoing. In the case of a business the benefits from making an investment are usually received over an extended period of time, while expenses are often up-front. This can complicate decisions about major pieces of capital equipment, and involve sub-calculations that take interest rates or lease fees into account.

In its simplest form a cost/benefit analysis is made using only current financial costs and current financial benefits. For example, a simple cost/benefit analysis of buying a new piece of earthmoving equipment would take into account only its purchase price (costs) and its expected earnings (benefits) over its useful lifetime. A more accurate approach to cost/benefit analysis would incorporate other factors such as depreciation, interest on money borrowed for the purchase, the expenses of maintaining the equipment, and operator's wages.

Analysis needs a common unit of measurement

To reach an accurate conclusion about the desirability of a course of action all positives and negatives must be expressed in terms of a common unit, which is usually money, although it can be any unit from degrees of temperature to miles traveled if that suits the purpose of the analysis.

Another concern is related to the actual value of money over time. A project that costs a million dollars today and will bring in five million dollars over the next ten years isn't really giving an ROI of 5 to 1. A dollar received in ten years will be worth much less than a dollar received today.

Options need to be given consideration

When a course of action is being evaluated the analysis must include estimates of what benefits and costs will be if the action isn't taken. By not proceeding with a new hospital the benefits will be a savings in expenditure but costs might include funds to beef up existing health services in the area to cope with population growth, as well as the additional costs of declining health standards.

On a larger scale, if a company in California is considering relocating to Tennessee it must consider such factors as the costs of retrenching much of its workforce, the costs of moving across the country, the costs of the new facility, the costs of recruiting and training new staff, and a host of other expenses. The benefits would hopefully come from moving to a lower cost labor market with perhaps better transportation links to key customers.

There are a number of software tools available to help with complicated cost/benefit analyses. Easier analyses can be done using just a spreadsheet. There couldn't be any easier way to guide you in making decisions, yet it's so simple it's often overlooked. The real challenge is to ensure that you accurately identify and calculate both the costs and the benefits of the intended action.

