

How to Make Decisions: How to Do a Cost Benefit Analysis In 3 Easy Steps

Money makes the world go around, and decision making is no exception. Cost Benefit Analysis does exactly what it says; you analyse costs and benefits and make a decision accordingly. Learn how to do a cost benefit analysis in these 3 easy steps.

A word of warning; cost benefit analysis is not an exact science. There is an element of guesswork and subjectivity which can never be erased. It is your job to use your skills and experience to make your best decision with the information you have at the time. Consider the alternatives - running a project with no idea of the financial impact or worse still, suffering from "analysis paralysis" and never getting anything off the ground due to fear of "what if's" or getting it wrong.

Cost Benefit Analysis Step 1 - Cash is King

The first step in a cost benefit analysis is to establish a common measurement unit - usually money. Sounds simple, but remember the time value of money - a dollar in the hand today is worth much more than a dollar in the hand in a year's time. For most businesses, cash-flow is crucial, so if income is slow to appear, can you manage the outgoings in the meantime? Also, some costs or benefits are one-off or may be ongoing.

Cost Benefit Analysis Step 2 - Let's Talk Money

The next step is to quantify the costs of doing the project and the resultant benefits. Costs often include; new equipment, specialist help, staffing, training, maintenance, lost business during implementation etc.

Benefits can be harder to quantify. There may be obvious benefits such as direct cost savings, reduction in rework, fewer customer returns etc where you can calculate a solid financial benefit. However there may be some intangibles like increased customer loyalty or employee satisfaction, which are tricky, if not impossible, to put a price against.

Cost Benefit Analysis Step 3 - It's Payback Time!

The final stage is to calculate the "pay-back" time for the project. If the total costs are \$40,000 and the ongoing benefits are \$60,000 per year, the pay-back period could be calculated as $\$40,000/\$60,000 = 8$ months. If your business is going down fast, 8 months may be too long, but at least you've got some idea of what's involved. Ultimately, the final decision is yours.

A cost benefit analysis can be a critical part of decision making, and not just for accountants. Careful consideration of the financial implications of your decision BEFORE you make it, can mean the difference between rags and riches.

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