Who the Heck Needs ROI?

Anthony Sarno ProveIT.net
Robin F. Goldsmith, JD Go Pro Management, Inc.

There's a good chance that you should and could be using Return on Investment (ROI) more than you currently do or even realize.

ROI is the way to measure Value and determine, objectively, whether what you want to do will pay off and whether what you actually are doing is paying off.

Are you missing the real ROI?

Many organizations explicitly require formal ROI calculations for certain events, such as determining whether or not to go forward with a proposed project or making a major purchase, especially when choosing among competing vendors. Such formal ROI calculations often are presented within a written business case.

Regardless of whether the need for calculating ROI is explicitly required, or even recognized, smart managers understand that knowing ROI is a key to success in many situations, including making strategy and other major decisions, buying and selling complex products and services, and participating in projects both as project manager and as a key stakeholder or contributor.

Measuring the variables affecting success

Actually, it's often not the ROI calculations themselves or the communication in a business case that are so important. Rather, the real effectiveness advantage frequently comes from developing in-depth understanding of the key variables affecting success sufficiently to quantify them financially with ROI as well as operationally.

Having such a handle on costs and benefits provides an added powerful perspective that many managers miss; and though they may not have been aware of it, not knowing the dollars and cents may well have been many a manager's undoing.

Even in the best of times, proposed projects and other initiatives must compete for limited resources. As availability of funds declines, proposals which fail to clearly, credibly, and convincingly identify adequate benefits beyond costs will be rejected outright or will be passed over in favor of those that do. Organizations expect expenditures to produce a visible return and recognize that identifying benefits is a prerequisite for assessing an investment's value. Many require a formal cost and benefit analysis prior to an investment actually being made.

Managers frequently are attentive to the Manager's Triangle triple constraints (product functionality and quality, cost, and schedule), which are like three of the legs of a chair. However, they often may be oblivious to the fourth leg—Value as measured by ROI. Three-legged chairs are a shaky basis for managing business. You need to know your ROI too.

ROI and Why It Isn't Used

No doubt the biggest reason people don't use ROI as much as would be helpful is that ROI just doesn't occur to them as something that indeed would help them do whatever they're doing. For those who do consider ROI, preparing a business case may seem like more formality or effort than they want, there can be controversy about the effectiveness of ROI as commonly calculated, and frankly probably most commonly the calculations just seem to scare a lot of people.

A business case is a written description of the rationale for proposed approaches. Supporting the rationale are calculations showing the financial Return, or benefit, relative to the Investment cost of achieving the Return--ROI. An approach's Return typically is portrayed by contrasting the approach's cost and revenue cash flows with those that could be expected if there were no change (Business as Usual). A business case is not necessary in order to use ROI.

Risk, reward and payback

Typically, ROI users calculate two basic measures. The simpler measure is payback period, the length of time it takes for the cumulative Return to equal the cumulative Investment cost. Ordinarily investment spending must occur before the investment starts producing benefits. The longer an investment's payback period, the riskier and less attractive the investment is. Similarly, the larger the initial investment, the riskier and less attractive it is; and not surprisingly, larger investments usually take longer to payback. These days, organizations want very quick payback periods, preferably by yesterday.

The more complicated measure, which most commonly is what is called "ROI" and can include additional intimidating calculation variations, depicts ROI as an annualized percentage, which then can be compared to the annual percentage return from competing proposed alternative investments. For example, an essentially risk-free bank certificate of deposit might pay interest at a rate of 3 percent per year. A proposed alternative investment would need to promise a somewhat greater annual return in order to compensate for the increased risk, such as the possibility that the proposed approach doesn't provide the expected benefits or doesn't get done on time for the expected cost.

Many question the suitability of calculating ROI at all, especially those who can't find the financial return for an investment they favor. They may say the return is so obvious that ROI calculation is unnecessary. The fact is, to borrow Samuel Goldwyn's famous depiction of oral contracts, many ROI analyses as commonly performed indeed "are not worth the paper they're written on." The usually-raised issues with ROI frequently reflect inappropriate understanding or usage, which of course are real issues but are not inherent to ROI.

REAL ROI™

In our experience, the ROI issues most people express are like the iceberg's tip. The far larger source of ROI difficulties are like the 90 percent of the iceberg below the surface that people generally aren't aware of. We've identified 10 common pitfalls people aren't aware they frequently encounter when determining ROI, which means that very often the ROI people do rely on indeed is not right.

Identify right requirements for real ROI

For example, the most important of these seldom-recognized ROI shortcomings is the failure to link the ROI calculations adequately to what really provides value, usually because the REAL business requirements which provide value when met have not been identified adequately. A related reason is focusing too much on the arithmetic calculations and too little on getting the right numbers for the right things for those calculations. Among the right numbers that typical ROI almost always misses are quantified intangibles.

Thus, not only do people tend not to realize many of the instances when they could benefit from using ROI, but also the ROIs they do calculate often are less reliable than recognized.

ProveIT's REAL ROI™ methodology overcomes these and the rest of the 10 common ROI pitfall problems to determine right, reliable, and responsible ROI; but that's not the topic of this article. Information on REAL ROI™ and the powerful Problem Pyramid™ tool it uses to identify and quantify REAL Value can be found on www.ProveIT.net and in Robin Goldsmith's recent book, *Discovering REAL Business Requirements for Software Project Success*.

Rather, the remainder of this article describes some of the often-unrecognized types of roles and situations where professionals could and should know the ROI; and if they do follow this advice to know the ROI, the ROI they determine should be the REAL ROI™.

Decision Makers

Decision making is the day-in-day-out activity of all levels of management, not just senior executives. Dozens of decisions are made every day, often without the decision maker being consciously aware of making a decision. Decisions can involve choosing strategies, tactics, methodologies, markets, product and service lines, staffing, technology, all the way down to paper or plastic.

"Strategy" often seems to be used as a buzzword term more than as an actual management practice. An organization's strategy identifies how it intends to go about meeting its mission. Strategy determines the types of products, services, and markets an organization will pursue and the ways it will pursue them.

Do you close shop when WalMart moves in?

For example, WalMart has become the largest retailer by assiduously following a strategy of offering the lowest prices on a wide range of average-to-low-quality consumer products. WalMart's arrival in a locale often drives smaller directly-competing local merchants out of business. However, some small boutique and specialty stores still prosper despite the giant's presence by taking different strategies, such as offering a limited selection of unusual or very high quality merchandise and services, for which they may even be able to charge premium prices. Appropriate ROI analysis could be critical for determining whether or not opening or keeping open a retail store that competes with a nearby WalMart will be fruitful or an enormously expensive strategic mistake.

When the economy worsens, organizations commonly adopt a strategy of cutting training, quality assurance, and marketing expenses. In many instances, such almost kneejerk decisions actually may create results directly opposite those intended, cutting capability, and quickly spiraling the organization downward into almost certain demise. Thorough ROI analysis that takes all key relevant variables into account, especially quantifying intangibles, very well could reveal the value of an alternative strategy. For instance, it might show that holding steady or even increasing these commonly-cut activities actually would increase chances of survival.

Ultimately, every decision should be based on net financial benefit. Yet, many decisions aren't, partly because most decisions are made informally and partly because the benefits may seem intuitively obvious. Ironically, higher-ups dealing with bigger and more far-reaching issues often are the worst offenders.

Why some formal ROI processes fail to solve problems

A recent experience with a large financial services client is probably too typical. Prompted by a recurring problem of projects' running over budget and deadline while still failing to deliver adequate value, the client requested extensive assistance training business analysts how to improve their requirements discovery to better feed a formal project approval process which included ROI.

The analysts learned valuable skills but were limited in their ability to apply them. Our own analysis revealed that the analysts repeatedly were put into projects that inadvertently constricted the analysts' ability to define solutions which provided sufficient value. Long before undergoing the formal approval process, projects already were being destined to difficulty by a project initiation process based only on the well-intentioned intuitions of the senior executive group.

The executives needed the analysts' assistance during project initiation to provide sufficient understanding of the REAL business requirements and the quantified financial value they achieve when met, which are essential for the meaningful ROI analysis that effective project initiation decisions are based on.

Intuitive Decision-making

Some management gurus suggest that intuitiveness is a key top executive decision differentiator. While gut feel surely does sometimes turn out right, intuitive decisions in fact are likely to be ill-advised far more often than realized. Moreover, political dynamics probably make realizing a high-level decision's weaknesses exceedingly unlikely. Often the person making a questionable decision is the one charged with judging the decision's worthiness. They'll no doubt dismiss or even punish any challenges; and an "Emperor's new clothes" effect can arise whereby nobody dares question the decision's wisdom.

Looking for justification is a pitfall

Even when ROI is calculated for decision making, it's often characterized as "justification." This term is a tip-off of one of the 10 common ROI pitfalls: that a decision is expected to be made based only on information supporting a pre-defined answer, rather than assisting objective decision analysis. Not surprisingly, decisions which are "justified" have a way of being unreliable. The level of the proponent not only doesn't reduce this risk but in fact probably increases it, since "justification" of decisions favored by politically influential folks are less likely to be questioned, especially when the proponent is also the decision maker.

Failing to quantify intangibles, again typically unwittingly, is a related way to justify taking a favored approach while appearing to subject the decision to hard scrutiny. The common technique of financially quantifying tangibles but merely separately listing intangibles without quantification actually provides an out—a way to justify a desired approach even when well-reasoned tangible ROI has been calculated and doesn't support the favored action.

Getting right, reliable and responsible decisions

Decision makers need to know the right, reliable, and responsible ROI so they can make their many large and small decisions pay off more effectively. They need to know the ROI before undertaking courses of action; and they need to periodically revisit the numbers to make sure that the chosen course of action continues to produce desired value for reasonable investment cost.

Gut feel decisions, which inevitably are based on inadequate requirements and often merely justify ill-conceived predefined solutions, can give the illusion of sound management while actually leading the organization to waste scarce time and resources on actions that don't pay off adequately. Moreover, people are less likely to commit to carrying out decisions successfully when they feel the financial benefits don't seem to add up.

On the other hand, when informed ROI financial analysis is integral to the decision making process, strategy and similar decisions are far more likely to lead to success and implementation buy-in.

Buyers

Financial ROI analysis probably is used most commonly by organizations when they must choose among competing vendors/offerings in order to buy a product, system, software, tool, or services. Organizations typically follow often very time-consuming and expensive purchasing procedures, including involving legal assistance to structure contracts with selected vendors.

Buying represents a special form of decision making. Especially in a tight economy, buying as opposed to building a solution often can be a way to save significant time and money. In fact, where both are options, a decision whether to build or buy should be made first based on the two approaches' respective ROIs before proceeding to select and engage a specific vendor/product solution.

It's usually cheaper to buy something that already exists than to build it. Implementation time is more immediate because there's no delay waiting for it to be built. Risks ordinarily are lower because an existing product or system can be evaluated, and its costs generally can be identified more precisely, whereas there's no way to be sure what actually will be the result, duration, or cost of a development project. By the way, outsourcing is the buying of the building and thus actually can both decrease and increase risks.

Selecting a vendor

The reliable way to select a vendor/product is to prepare an ROI calculation for each competing vendor/product solution and pick the one that provides the most advantageous ROI over the expected useful life of the solution. It's essential that the calculations for all competing choices are based on providing equivalent results. Thus, an appropriate Request for Proposals (RFP) should charge the vendor with proposing a solution which will meet the buyer's REAL business requirements and thereby provide Value. An RFP does not have to be overly formal, but it must adequately inform vendors what their solution must achieve.

If a proposed vendor/product cannot meet certain requirements, the scenario and costs/benefits describing the vendor's solution must be adjusted to reflect what is necessary to enable that solution to meet the requirements. For example, the scenario may also need to include customization and/or some supplementary products and services, such as additional support.

However, in spite of applying all sorts of seemingly good procedures to protect themselves by assuring they purchase the vendor's product in a responsible manner, including conventionally calculating ROI, many purchases in fact still go awry. For far too many (some might say for most) complex purchases, especially of software, expected ROI never materializes. Such purchases frequently fail to deliver desired results, take too long, and/or cost too much.

Are you buying based on product design or requirements?

Buyers often buy the wrong products because they don't understand important acquisition concepts that make purchasing complex products much different from buying something at the mall. Most buyers describe what they want to purchase in terms of a presumed product/system design, rather than in terms of their REAL business requirements that the product/system must satisfy in order to provide value. This mistake is aggravated when buyers focus on what the vendor is selling rather than what they, the buyers, actually need.

ROI calculations will be inadequate when they are based only on price, without taking into account the total cost of ownership (TCO) and the other half of the ROI equation—value received. TCO must include costs to install, operate, support, and possibly retire the product/system solution over its life. Revenue as well as expense impacts on all affected parties must be reflected. Factors such as risk must be addressed, and both tangibles and intangibles must be quantified financially.

Sellers

Effective sales people help their prospective customers become effective buyers—purchasing products and/or services which provide the most advantageous ROI by meeting the buyer's REAL business requirements that provide REAL value from the buyer's perspective.

Typically to save themselves the effort of calculating vendor ROIs for their internal buying process, buyers often request sellers to provide ROI figures for their products/services. Even when not requested, many sales people quote ROI as a way to make their product/service look more attractive; and many vendors have ROI calculators that justify buying their product.

What are vendor supplied ROI calculations worth?

Unfortunately, such vendor-calculated ROIs frequently are neither convincing nor correct. Many sales people mainly pay lip service to customer needs while largely focusing on their product's differentiating features, presuming that whatever their product does must indeed provide value. Despite saying it's important to listen to customers, many prominent sales training methodologies essentially encourage product-based sales pitches and claimed product ROIs. It should be pretty obvious why they tend not to be believed—or bought.

On the other hand, sales efforts can receive a much different positive response when they believably show right, reliable, and responsible ROI based on meaningfully understanding and explicitly linking the vendor's product to satisfying the buyer's REAL business requirements that provide Value when met. Of course, this involves actually listening to the prospective customer and learning how to discover what they really need and value; but that's what truly effective sales people know is their highest-payback activity.

Become a valued partner

Sales people who take this approach can become valued partners in their prospective customer's buying process. Moreover, both the seller's sales process and the buyer's buying process actually can be made quicker, cheaper, and easier. A seller who has earned trust by understanding how their product delivers what the customer really values dramatically reduces the effort needed to make a sale.

In turn, the buyer doesn't need to spend so much time on the typical defensive acquisition procedures occasioned by vendors who are not believed; and the buyer even can save effort by actually being able to rely without significant recalculation on the vendor's credible calculation of ROI for their proposed solution.

Project Managers and Other Stakeholders

Money is the language of business and usually is important to many more of a project's stakeholders than just senior management. While task completion and deliverables are key measures of project progress, ultimately project success is measured in money—whether the Return value received adequately exceeds the Investment cost, including the quantified costs of time, risk, and other intangibles.

Therefore, even though calculating and reporting ROI generally is not a typical explicit project manager responsibility in most organizations, project managers and other stakeholders would be well advised to understand their project's ROI finances so they can continually monitor and communicate ongoing ROI status throughout and upon completion of a project to be sure expected REAL Value is delivered.

Real professionals look at real ROI

Any discrepancies should be analyzed and adjustments should be made accordingly to both the present project as well as to the estimating process so future projects will benefit from improvements.

Project managers who know and report financially with respect to ROI Value usually will be perceived as more professional and capable than those who pay attention only to budgets and schedules. Similarly, stakeholders with an interest in receiving Value will be more likely to get it when they measure and monitor ROI Value returned relative to Investment cost.

Anthony Sarno is CEO of ProveIT (www.ProveIT.net), which provides REAL ROI™ and ROI Value tools, training, and advisory assistance for decision makers, buyers, sellers, project managers and other stakeholders. He can be reached at asarno@ProveIT.net or 866 772-0168 x501.

Robin F. Goldsmith, JD is President of Go Pro Management, Inc. (www.gopromanagement.com) and partners with ProveIT on REAL ROI™, ROI Value Modeling™, and the powerful Problem Pyramid™ featured in his recent Artech House book, *Discovering REAL Business Requirements for Software Project Success*. He can be reached at robin@gopromanagement.com or 781 444-5753.