ROI Basics

By Jack and Patti Phillips

Once you understand the basics of the ROI Methodology, the natural chain of impact really begins to make sense.

Many company owners who decide to measure return on investment for various projects and programs realize that deciding how to do it accurately and effectively can be confusing. How do you determine which costs to include in you calculation? Can you really isolate the business impact of any one program? Measuring ROI doesn't have to be difficult. And it is so important a measurement that we actually developed the "ROI Methodology" to make it easier for companies, large and small, to make that all-important calculation. Once you understand the basics of the methodology, the natural chain of impact really begins to make sense.

In a previous column, we discussed how the use of ROI has moved to non-traditional areas. It is no longer restricted to a process that shows the value of a company's buildings and equipment. ROI is now being used to show the value of technology projects, human resources, quality, and marketing initiatives. In fact, ROI can be evaluated for virtually any policy, program, project, process, or system. Let us show you how with a quick course in Phillips' ROI Methodology 101.

Imagine any project that you are implementing -- it can be a new sales strategy, new software for the company, or a new absenteeism control process for your workforce. Let's think about how the project unfolds and the data we will collect. The process follows a simple, logical chain of impact.

The first set of data would be reaction. People must see the project as helpful, useful, and necessary -- perhaps even important -- to them personally. Adverse reaction spells disaster, and the project dies. A positive reaction often means that it will go even further.

Learning is the next measure. Even if it is a new policy, participants must learn what they have to do to make any project or program successful. If it is new technology, they must first learn how to use it before they can apply it. We must measure learning in a simple, informal way. And simply put, we have to determine if they actually know the new material. If they need more structure, which is generally the case, we give them a test with self-assessments.

The chain of impact then takes us to the next level -- application. Participants need to do something with what they have learned. We want them to implement the project, use the policy, or use the software. This is very important, because so many projects fail at this level. We must understand that if they are following the process, there are simple follow-up measures that will easily determine if the program is working properly. If it is not, then it is important to find out what is getting in the way.

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Application involves activity, and the consequence of that activity is impact, the next level of evaluation. These measures could include sales, productivity, cycle time, errors, absenteeism, employee turnover, customer satisfaction, and job satisfaction. The impact measures are huge and represent the consequences of implementing the project properly.

This data is extremely valuable. It shows the business contribution of our project. But collecting the data is never enough. There are some things that we have to do to make it credible.

Most important to calculating a credible ROI is isolating the effects of our project on the data. You see, we know that many other factors could have contributed to these measures. Take the simple sales example we put in a new sales strategy. Sales increase, and often there are many factors causing it. So we must deliberately take a step to isolate the effects of our project on the measure. In other words, we only take credit for that part. There are many ways to achieve this -- far beyond what we can discuss in this column. You have a complete option, and we suggest that you always have a technique in place to isolate the effects of the program. Otherwise, there will be no credibility.

For the next step, we must convert the data to money. To get the ROI, we need monetary benefits, which are converted from the impact measures. For some, this is very easy. For example, if the business impact is in sales we use the profit margin. For waste and rework we use standard cost of quality. For absenteeism, turnover, and accidents we use standard data or experts in the organizations. It is often very easy to find the data, and an expert in a company or an industry often has already converted it to money. If it is something we want more of, like productivity or sales, we look at the value add. If it is something we are trying to prevent or reduce, then we look at the cost savings. With the money we decide, "So how long do we consider this benefit to be?" To be conservative, we go for one year. Sometimes we extend that, depending on the scope and nature of the project. We take the monetary benefits for one year and compare it to the entire cost of the project. We must include every direct and indirect cost so that it is credible. These two figures come together as cost verses benefit to give us ROI.

We express ROI in two ways. First, the benefits divided by cost is called the benefit-cost ratio. For example, if we had a project that cost $500,000 and the benefits are $750,000 then the benefit-cost ratio is $1.5. This means that for every dollar that we invest, we receive $1.5 in benefits. However, the financial community does not use benefit-cost ratio, so we have to convert it to ROI. We take the benefits minus the cost (that's the net or the earnings on this project). Now we divide that by the cost -- multiply it by 100 to get the percentage. That becomes the ROI, expressed as a percent. In the previous example, benefits of $750,000 with cost of $500,000 yields a benefit using ROI of 50%.

Many projects do yield positive ROI. Unfortunately, others do not. We will deal with some of the other issues around this process in subsequent columns. We just want to show you how simple, rational, and logical this is. The rules and standards of the methodology will give you a pretty credible ROI calculation. These will be covered later. But remember the basics. Follow the chain of impact to determine the program's value in monetary terms. Simple!

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