Right, Reliable, and Responsible REAL ROI™

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All decisions ultimately are based on value: Does the expected benefit Return exceed the Investment cost? Return on Investment (ROI) is the accepted way to quantify this value equation.

Unfortunately, too many strategy, buying, and selling decisions go wrong because they are based on incorrect, unreliable, and irresponsible perceptions of expected benefits vs. costs.

In hindsight, it probably should have been apparent that undesirable outcomes are inevitable when important decisions are made subjectively without being based on explicit reliable ROI. Worse still, though, many of those who do calculate ROI explicitly actually fail to gain an adequate, accurate, and believable basis for guiding their decisions; and they usually don't have a clue they're going astray!

Thus, organizations often have two problems which exacerbate their damage. Not only may they be relying on illusory ROI; but also they're probably doing so thinking their ROI calculations cover their bases. Such unfounded confidence actually leaves them more vulnerable to the very risks ROI analysis was supposed to reduce.

REAL ROI™

REAL ROI™ is ProveIT's superior method for determining ROI in ways that overcome ten common ROI shortcomings to produce credible and convincing financial analysis which is right, reliable, and responsible.

1. **REAL ROI™ objectively analyzes alternatives' financial aspects.** Meaningful financial analysis provides the decision maker impartial input to their decision. It identifies the financial implications of all key strengths and weaknesses of each alternative. In contrast, many uses of ROI actually are merely justifying a predefined answer. Most justifications mainly present factors favorable to the preferred choice and factors unfavorable to the other choices.

   People inherently suspect and often disregard one-sided views. However, when presented by colleagues, even when called "cost justification," the one-sidedness can be hard to detect. Justifications frequently provoke vague feelings of uneasiness, although the reason may not be apparent. On the other hand, prospective buyers generally assume that ROIs claimed in typical sales pitches are blatantly one-sided and not to be believed. Determining and communicating a product's REAL ROI™ can help make a salesperson more credible and convincing.

2. **REAL ROI™ directly links proposed solution capabilities to Value.** Value comes from satisfying REAL, Business Requirements—business deliverable *whats* that provide value when delivered, met, or satisfied by a product/system/software *how*. We use the powerful Problem Pyramid™, as described in my recent book, *Discovering REAL Business Requirements for Software Project Success*, to identify the REAL Problem/Challenge/Opportunity, measures of Value (from solving the Problem, taking the Opportunity, or meeting the Challenge), as is Causes, and the should be REAL business requirements. Then we explicitly link the differentiating features of proposed solutions to the REAL business requirements they satisfy and thereby provide quantified financial Value.

   In contrast, most projects and sales people focus primarily on the product/system/software proposed solution they want, which they presume is the value. The proposed solution provides value if and only if it meets the REAL business requirements, which often fails to happen largely because the REAL business requirements haven't been defined adequately, mainly because most people focus on what they want to create rather than what it needs to accomplish.

3. **REAL ROI™ measures all relevant revenue and expense benefits.** Expense-related benefits go directly to the bottom line, which makes them especially attractive in the short term. The most common expense benefit is *savings*, which comes from no longer spending money you have been spending. Unfortunately, the most common way to achieve savings is by eliminating jobs. A somewhat more palatable expense benefit is *avoidance*, which means not incurring some future additional expense which otherwise would be incurred, such as not having to hire extra staff.

   However, there's a practical limit to how much expense can be cut; and cutting too much expense can impact the organization's ability to function. In fact, expenses can be reduced to zero by ceasing operations, which ordinarily is not a desirable outcome.

   Ultimately, business vitality depends on benefits related to revenue. Realize, though, that only a portion of revenue called the profit margin goes to the bottom line. That is, there is a cost of producing the revenue which must be subtracted from the gross revenue to net the profit. Revenue benefits come from enhancement and protection.

   Revenue *enhancement* means increasing money received. Enhancement comes from selling more, such as by increasing the number of customers and/or increasing the amount each customer buys. Increasing prices also can enhance revenues if the higher prices don't adversely affect volumes; and increasing collection amounts or rates enhances revenue.

Revenue *protection* means keeping the revenues you currently receive. For instance, it may be necessary to offer additional products or services which may not even be profitable themselves, simply because competitors already offer them. It's the price of keeping customers from defecting to the competitors who first offered the added products and services. The other big source of revenue protection is *compliance* with laws and regulations. Ultimately the price of failing to comply is restriction on your organization's ability to do what it does to generate revenue.

In contrast, many typical ROI determinations often focus on cost savings as the only benefit. This causes others in the organization, especially those involved with revenue, to feel that ROI isn't relevant to their needs. They're right when their organization doesn't understand that ROI should include more benefits than just cost savings.

4. **REAL ROI™ identifies total investment cost of ownership.**
   Total cost of ownership (TCO) includes the costs of operating and supporting the solution over its useful life, as well as the initial price. When calculating ROI, TCO needs to be calculated for each alternative solution being considered, including the "no change" Business as Usual (BAU) alternative. Net benefits are the difference between the alternative's full-life benefits minus its TCO and that of the BAU scenario.

   Many ROI calculations consider cost to be only the initial price. Of course, anyone can meet a deadline and have a low price if you don't care what you get. The quickest way to lower the price is to move cost factors into operations and support. This is what happens when inadequate products and systems are delivered with inadequate quality, regardless whether it's done by an outside vendor or an internal development organization.

5. **REAL ROI™ addresses the solution's full reasonable useful life.**
   TCO and corresponding total benefits should be included for the project's full useful life. For instance, the typical accounting convention is to treat the useful life of information system development as if the system will last for five years. (Some organizations use a more aggressive three-year useful life.) The useful life length is the same for all such projects, even though some systems have been in use for 20 or more years and other systems won't last more than a year or two.

   In contrast, many organizations compute ROI within an immediate 3-6 months timeframe, often because they need the benefit that soon. Failing to take into account the later revenues and expenses can provide a misleading picture.

6. **REAL ROI™ emphasizes identifying right contributors to value.** REAL ROI™ is made meaningful by telling the "story" of how each alternative product solution *how* satisfies the REAL business requirements deliverable *whats* that provide value when met. The story identifies all the key contributors to value and makes it clear that they are the right contributors by showing rationally how together they meet the REAL business requirements.

   The story then becomes the basis for quantifying the contributing factors and multiplying each by its relevant per unit revenue or expense. With such right and reliable financial inputs, the actual ROI calculations are straightforward and, frankly, secondary.

   In contrast, many typical ROI efforts and consultants mainly concentrate on the calculation formulas. Granted, many people are unfamiliar with ROI calculations and many people apparently are intimidated by even fairly basic arithmetic; but it's the figures that go into the calculations, not the arithmetic itself, that makes ROI calculations useful.

   A variation on this mistaken focus is the ubiquitous canned "ROI calculator" spreadsheet promulgated in so many articles and vendor websites. That is, the calculator relieves mathematics angst and makes ROI mindlessly mechanical by doing the "overwhelming" calculations for you.

   There are only two problems with most calculators. First, such calculators almost always are showing one-sided justifications of whatever the calculator's author is promoting. Second, making the ROI determination mindless generally makes it meaningless, because it strips out the important story that is the basis for believable figures in the calculations.

7. **REAL ROI™ addresses impacts throughout the enterprise.** Responsible ROI recognizes and accounts for all key expense and revenue impacts of the proposed solution no matter where they occur within the organization. Such impacts could be positive or negative, but they need to be factored in to tell the full story and guide resulting ROI calculations.

   It's common for typical ROI calculations to include impacts only on the primary area receiving the benefits. Whether intentional or not, this can have the effect of distorting the real impact of proposed solutions. For instance, new systems frequently are touted for introducing efficiencies in one department; but often without recognition, especially in the ROI claims, the process may actually shift or create additional work for some other department.

8. **REAL ROI™ includes impacts outside the enterprise.**
   Responsible ROI also identifies and accounts for expense and revenue impacts of proposed solutions outside the organization, especially on partners and customers, but also on the industry, community, and others who may be affected. All need to be included in telling the full story and determining the REAL ROI™.

   Typical ROI looks only internally, which can mask important meaning and misguide decisions by addressing just the tip of the iceberg. For instance, organizations increasingly cut their own internal staff costs by laying work off on customers, frequently characterizing it as more convenient for the customers but failing to assess the true costs to the customer and resulting impacts on the customer's buying the organization's products and services.

9. **REAL ROI™ addresses risk and other relevant financial variables.**
   For ROI to be right, it needs to recognize and reliably take into account financial impacts of factors such as risk, timing, growth, and other variables that can so significantly affect the expected costs and revenues of a proposed solution.

   Too often, traditional ROI presents a misleading picture because it overlooks or inappropriately addresses such factors. For instance, unfounded estimates frequently are quoted as ranges on the premise that it's reducing risk. In fact, such ranges actually present two unfounded estimates, which in fact can add to risk because the range can give the illusion that the proper figure is somewhere within the range when it's not.

10. **REAL ROI™ quantifies both tangibles and intangibles.**
    Many projects are undertaken to achieve benefits which ordinarily are characterized as intangible, such as, doing noble or charitable works, improving customer service, or improving management information. Similarly, costs and other factors sometimes seem intangible, such as when a system is hard or unpleasant to use. REAL ROI™ quantifies all these relevant intangibles because it's necessary to correctly balance them against the tangible money needed to accomplish them.

    In contrast, typical ROI, including the way most ROI consultants advise, quantifies tangibles but simply lists intangibles. This creates a giant loophole which can nullify all the work quantifying tangibles, because it enables overriding disfavored ROI results on the unchallengeable premise that the unquantified intangibles outweigh the quantified tangibles.

ProveIT's experienced skilled professionals assist, train, and guide you in identifying, calculating, and presenting REAL ROI™.

Robin F. Goldsmith, JD consults, speaks frequently at leading conferences, and presents both public and in-house seminars. He is the author the REAL ROI™, Proactive Testing™, and Beyond the Textbook™ acquisition and outsourcing methodologies, as well as numerous articles and the recent Artech House book, *Discovering REAL Business Requirements for Software Project Success*.

Since 1982, as President of Go Pro Management, Inc. consultancy of Needham, MA, Robin has provided senior professional advisory assistance working directly with and training business and systems managers and professionals. Robin specializes in quickly and insightfully understanding his client's REAL business requirements, utilizing operational and financial measurements to achieve more effective and efficient management processes, and improving software development/acquisition quality, testing, and productivity.

Mr. Goldsmith partners on REAL ROI™ and ROI Value Modeling™ with ProveIT.net, LLC, a value-focused software and technology services company providing REAL ROI™ training, tools, and assistance to aid buyers, sellers, and decision makers.