How Do I Measure Return on Investment? Part 2

So in Part 1, I have looked at the various ways in which your Return on Investment (ROI) can be delivered.

Here I want to look at the quantification process together with a section on risks. There – said it – terrified a whole bunch of accountants!!!

"Risk" – done it again!

Quantification

The very term ROI infers the process of deriving a number. This can be a percentage, a ratio, or sometimes is expressed as the period of time that would be taken for the investment to be repaid.

It is quite possible to get totally tied up in knots looking to define a truly meaningful number. It is very unlikely for example that the timing of your investment and returns will be simple. Accordingly, the costs and returns should really be discounted. This process is beloved by academics. The rate at which you discount is again a subject for debate. The mathematics fall under the heading of discounted Cash flow. Mathematicians will talk about Internal Rates of Return (IRR).

Not wishing to discount these theories (excuse the pun), in my view, the whole point of ROI is to compare differing investment opportunities either against each other or against a target rate. As such, to me consistency is probably as important as theoretical accuracy and deriving a number.

For this reason a simple percentage return or years payback calculation is perfectly adequate in most cases.

It is the process of identifying the benefits, quantifying them, and rubbing them up against the capital and revenue costs that brings about the benefit to the sponsoring manager.

Farmer Giles has £100,000. Does he buy a new combine harvester or does he buy his neighbours spare 12 acres. He should be able assess these two opportunities against each other. Of course, assessing a depreciating asset like a piece of machinery against an appreciating asset like land brings a whole other raft of complexities. We all know Farmer Giles will buy the land – that's what farmer's do, but comparing the two opportunities side by side is perfectly feasible.

In the world of systems the ROI process should force the sponsor to really examine what they want and why, and to understand that software, be it packaged, bespoke or an enhancement, has costs (often considerable) attached, and that as such benefits have to be identified.

As do risks.

Risks

Attached to any development process is risk. And let's be honest, in the case of IT development, this risk can be substantial. The risks associated come from a variety of areas

- The nature of software
  - Packaged
  - Bespoke
  - Enhancement
  - Hybrid
- The volatility of the core business process
- The sheer scale of the project

Without doubt, bespoke software carries an inherently greater risk than buying a package. The problem though with packaged software is that unless it fits your requirement well, the cost of closing the gap can exceed the cost of an entirely bespoke solution.

Packaged solutions for accounts, CRM, ERP, business communications or e-Commerce tend to work well.

ERP (Enterprise Resource and Planning) is often modified into business types or 'verticals' and again this can be a strong solution of your business or activity is well 'pigeon holed'.

Bespoke solutions can though work extremely well, especially to cater for niche businesses and operations. For most projects though, the important issue is getting a truly sensible estimate of time including contingencies. A day's development effort requires probably three times that by the time documentation and analysis, testing and implementation are taken into account.

Often the best solution is to go to a specialist software house that has a 'product' that is can modify to your exact requirement and then support that application.

But these all have risks.

Your knowledge of your own business process is often the biggest risk. To get those returns, you have to be able to accurately describe what you want. Often what Fred in Sales wants is diametrically opposed to Gladys in Accounts, and Said in Operations. Quite often the person who understands the minutiae of your process is the last person to get asked!

The other factor to consider is how volatile your business and its processes are. The more mature your process, not only do the risks diminish, but also the likelihood of suitable packaged solutions increases. If your business is young and cutting edge, then chances are that the lifecycle of any software investment will be shorter and much more pressured.

In summary, working out ROI is more art than science, and the pure number derived is arguably less important than having worked through the benefits, the costs and assessing the associated risks. If you do this, you <u>will</u> make better decisions.

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