

## The Importance of Costs and ROI

The costs of programs and projects are increasing, creating more pressure on managers to know how and why money is spent. Sometimes, the total cost of a program is required, which means that the cost profile must go beyond the direct costs to include all indirect costs as well. Cost information is used to manage resources, develop standards, measure efficiencies, and examine alternative delivery processes.

Tabulating program costs is an essential step in calculating ROI; program costs are the denominator in the ROI formula. Thus, it is just as important to focus on costs as it is to focus on benefits. In practice, costs are often more easily captured than benefits. This chapter explores the costs accumulation and tabulation steps, outlines the specific costs that should be captured, and presents economical ways to develop costs.

When ROI calculations are developed, understanding the alternatives to the ROI calculation and their relationship to each other is important. In addition, it is necessary to know what ROI means and how it should be used in an organization. This book shows how costs and ROI calculations are developed and how the ROI Methodology can be used as a forecasting tool. This opening chapter outlines the importance of tracking and monitoring costs, developing the ROI, and forecasting.

## Why Be Concerned About Costs?

Apart from the fact that cost figures are required for the ROI calculation, costs should be tracked and monitored for many reasons. Today's organizations focus on understanding and controlling costs; having an appropriate framework for keeping track of costs and using them in different ways allows a department or organization to be more efficient—an important advantage in a globally competitive market.

### Benchmarking

Many factors have contributed to the increased attention now given to monitoring costs accurately and thoroughly. Every organization must know how much money it spends on programs and projects and functions. Many organizations calculate these expenditures and compare the amounts with those of other organizations, although comparisons are difficult to make because organizations often have different bases for cost calculations. For example, some organizations calculate learning and development costs as a percentage of payroll costs and set targets for increased investment. In the United States, the average is about 2 percent, whereas in Europe it is 3 percent, and in Asia and Latin America it is 3.8 percent. The benchmarks are often the basis for developing financial allocation.

An effective system of cost monitoring enables an organization to calculate the magnitude of total expenditures. Collecting this information also helps management answer two important questions:

- How much do we spend on our function compared with other functions?
- How much should we be spending?

Exhibit 1.1 presents an exercise that may be helpful in addressing these two questions. The table focuses on setting a spending

**Exhibit 1.1. Setting Spending Amounts: How Much Should You Spend on Human Resources?**

	Your Estimate	Actual	Target
<b>Overall Expenditures</b>			
Total expenditures for human resources <sup>1</sup>			
Total expenditures for human capital <sup>2</sup>			
Spending on human resources as a percentage of payroll			
Spending on human resources as a percentage of revenues			
Spending on human resources as a percentage of operating costs			
Spending on human resources per employee			
<b>Functional Area</b>	<b>Your Estimate (percentage)</b>	<b>Actual (percentage)</b>	<b>Target (percentage)</b>
Needs assessment			
Development			
Delivery and implementation			
Operations, maintenance			
Evaluation			
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

(Continued)

**Exhibit 1.1. Setting Spending Amounts: How Much Should You Spend on Human Resources? (Continued)**

**Questions for Discussion**

1. Is there a significant difference between estimated and actual costs?

- Yes
- No

Explain: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

2. How did you determine what your targets would be?

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

3. What should you spend?

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

<sup>1</sup>Total expenditures for human resources = all costs associated with human resources (for example, recruitment, selection, development, compensation).

<sup>2</sup>Total expenditures for human capital = total expenditures for human resources plus the total salaries and benefits of all employees.

amount for the human resources function. The human resources manager could compare actual expenditures with those of organizations considered best practice.

Although this exercise focuses on setting the value for human resources spending, it can be adapted for any function—for example, learning and development, meetings and events, technology, or quality. In the first part of the exercise, estimate the expenditures in each of the areas. Make rough estimates, without making any calculations or searching for the data. Then fill in the actual expenditure in each area if it can easily be found or developed. If estimates must be developed, use a more reliable value than the initial estimate, including input from other individuals. Next, set a target for the expenditure, based on a desire to follow best practices, to overcome gaps in current spending levels, or to pursue other specific goals. Overall expenditures represent expenditures as they relate to organizational funding. Functional area expenditures are those for specific programming functions. The remainder of the exercise consists of questions that reflect on the issues in the exercise.

This exercise focuses on the process of setting spending levels, which are not clearly defined and are not given enough attention in many organizations. Although total spending levels are set by budgets, the process of arriving at those values is sometimes less comprehensive and less thought out than is desirable.

### **Evaluation**

The staff of any functional area should know the relative cost-effectiveness of their programs and the components of those programs. Monitoring costs by program allows the staff to evaluate the relative contribution of a program and determine how those costs are changing. If a program's cost rises, it might be appropriate to reevaluate the program's impact and overall success. Comparing specific cost components with those of other programs or organizations may be useful. For example, the cost per participant for one

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program could be compared with the cost per participant for a similar program. A huge difference may indicate a problem. Also, costs associated with design, development, or delivery of a program could be compared with those costs for other programs within the organization and used to develop cost standards.

When a return on investment or cost benefit analysis is needed for a specific program, costs must be developed. One of the most significant reasons for collecting costs is to obtain data for use in a benefit-cost comparison. In this comparison, cost data are as important as the program's economic benefits.

**Cost Forecasting**

Accurate costs are necessary in order to predict future costs. Historical costs for a program provide the basis for predicting future costs of a similar program or budgeting for a program. When an ROI forecast is needed, predicted costs must be developed. Sophisticated cost models make it possible to estimate or predict costs with reasonable accuracy.

**Efficiency**

Controlling costs is necessary in order to improve the efficiency of a functional area. Competitive pressures place increased attention on the need for efficiencies. Most departments have monthly budgets with cost projections listed by various accounts and, in some cases, by program. Cost monitoring is an excellent tool for identifying problem areas and taking corrective action. From a mere management standpoint, accumulation of cost data is a necessity.

**Other Reasons for Monitoring Costs**

Exhibit 1.2 summarizes why costs should be developed. As this list illustrates, there are many reasons why capturing costs is necessary, beyond calculating ROI.

### Exhibit 1.2. Why Develop Costs?

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- To determine overall expenditures
  - To determine the relative cost of individual programs
  - To predict future program costs
  - To calculate benefits versus costs for a specific program
  - To improve the efficiency of a department
  - To evaluate alternatives to a proposed program
  - To plan and budget for next year's operation
  - To develop a marginal cost pricing system
  - To integrate data into other systems
- 

## The Importance of ROI

“Show me the money.” There’s nothing new about this statement, especially in business. Organizations of all types want to see the money – specifically they want to see a return on their investments. What’s new is the method that organizations can use to get there. While “showing the money” is the ultimate report of value, organization leaders recognize that value lies in the eye of the beholder; therefore, the method used to show the money must also show the value as it is perceived by all stakeholders. Just as important, organizations need a methodology that provides data to help improve investment decisions. This book presents an approach that does both: it assesses the value that organizations receive for investing in programs and projects, and it develops data to improve those programs by providing all stakeholders with the information they need to make decisions. These decisions will drive change, improvement, and ultimately value for the organization.

### The Ultimate Level of Evaluation

ROI represents the newest way to state value. In the past, the success of a program, project, or process was measured by activity: number of people involved, money spent, days to complete. For example, Motorola measured success by ensuring that every employee must complete forty hours of learning annually. Other companies also used forty hours of learning as a benchmark of success. While utilization metrics describe the level of activity and consumption, these measures do not define value. Little consideration is given to the benefits derived from the activity. Value is defined by results, not activity. More frequently than ever before, value is defined as monetary benefits compared with costs: ROI. ROI is the ultimate level of evaluation. The following examples illustrate this point.

- The U.S. Air Force developed the ROI for an information assurance program to prevent intrusion into its computer databases.
- Apple calculated the ROI for its process improvement teams.
- Sprint/NEXTEL computed the ROI on its diversity program.
- The Australian Capital Territory Community Care agency forecast the ROI for the implementation of a client relationship management system.
- Accenture calculated the ROI on a new sales platform for its consultants.
- Wachovia developed an ROI forecast and then measured the actual ROI for its negotiations program.
- A major hotel chain calculated the financial value and ROI of its coaching program.

- The cities of New York, San Francisco, and Phoenix showed the monetary value of investing in programs to reduce the number of homeless citizens on the streets.
- Cisco Systems is measuring the ROI for its key meetings and events.
- A major U.S. Defense Department agency calculated the ROI for a master's degree program offered by a major university.

Although the ROI Methodology had its beginnings in the 1970s, it has expanded in recent years to become the most comprehensive and far-reaching approach to demonstrating the value of program investment.

### **Types of Values**

Value is determined by stakeholders' perspectives, which may include organizational, spiritual, personal, and social values. Value is defined by consumers, taxpayers, and shareholders in many different ways. Capitalism defines value as the economic contribution to shareholders. The global reporting initiative, established in 1997, defines value from three perspectives: environmental, economic, and societal.

Even as projects, processes, and programs are implemented to improve the social, environmental, and economic climates, their monetary value is often sought in order to ensure that resources are allocated appropriately and that investments reap a return. No longer is it enough to report the number of programs offered, the number of participants or volunteers trained, or the dollars generated through a fundraising effort. Stakeholders at all levels—including executives, shareholders, managers and supervisors, taxpayers, project designers, and participants—are looking for outcomes—improvement in output, quality, costs, and time—and in many cases they want a specific outcome: the ROI.

### ROI Is King

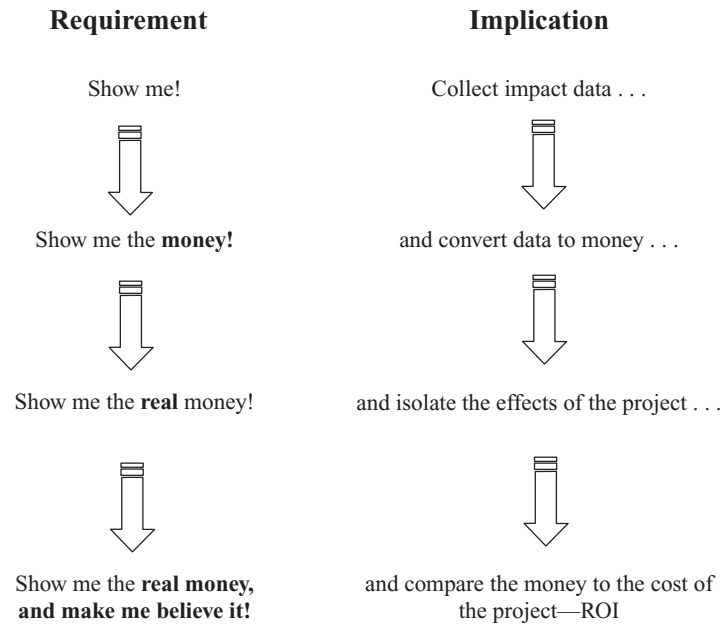
Some people are concerned that too much focus is placed on economic value, but it is economics, or money, that allows organizations and individuals to contribute to the greater good. Monetary resources are limited; they can be put to best use, or they can be underused or overused. In the French language, *roi* is the word for king, and ROI is indeed king, for determining ROI is the best way for organizations to show that their programs deliver monetary value to the organization. Organizations and individuals have choices about where they invest their resources. To ensure that monetary resources are put to best use, they must be allocated to the programs, processes, and projects that yield the greatest return.

For example, if a process improvement initiative is designed to improve efficiencies and it subsequently does improve efficiencies, one might assume that the initiative was successful. But if the initiative cost more than the efficiency gains are worth, has value been added to the organization? Could a less expensive process have yielded similar or even better results, possibly reaping a positive ROI? Questions like these should be asked on a routine basis. No longer will activity suffice as a measure of program results. A new generation of decision makers is defining value in a new way, by measuring programs' impact on business performance.

### The "Show Me" Generation

Figure 1.1 illustrates the requirements of the new "show me" generation. "Show me" implies that stakeholders want to see actual data (that is, numbers and measures). This impulse accounted for the initial attempt to see value in programs. This evolved into "show me the money," a direct call for financial results. But financial results alone do not provide the evidence needed to ensure that programs add value. Often, a connection between programs and value is assumed, but that assumption soon must give way to the need to show an actual connection by isolating the effects of the program from other influences. Hence, "show me the real money" was an

Figure 1.1. The Evolution of “Show Me”



attempt at establishing credibility. This phase, though critical, still left stakeholders with an unanswered question: “Do the monetary benefits linked to the program outweigh the costs?” This question is the mantra for the new “show me” generation: “Show me the real money, and make me believe it.” This demand is answered by measuring ROI. But this new generation of program sponsors also recognizes that value is more than just a single number: value is what motivates the entire organization. Hence, the need to report value based on the definitions of various people throughout the organization has arisen.

### The New Definition of Value

The changing perspectives on value and the shifts that are occurring in organizations have all led to a new definition of value. Value is not defined as a single number. Rather, value is defined by a variety of data points. Value must be balanced with quantitative and qualitative data, as well as financial and nonfinancial data. The data

sometimes reflect tactical issues, such as activity, as well as strategic issues, such as ROI. Value must be derived from different time frames and not necessarily represent a single point in time. It must reflect the value systems that are important to stakeholders. The data that are used to assess value must be collected from credible sources, using cost-effective methods; and value must be action-oriented, compelling individuals to make adjustments and changes.

The processes used to calculate ROI must be consistent from one program to another. Standards must be in place so that results can be compared. These standards must support conservative outcomes, leaving broader assumptions to decision makers. The ROI Methodology presented in this book meets all the preceding criteria for assessing value. The ROI Methodology generates six types of data that address the issues raised by the new definition of value: reaction and perceived value, learning and confidence, application and implementation, impact and consequences, return on investment, and intangible benefits.

## Why ROI Now?

In recent years, a variety of forces have driven additional focus on measuring the impact of programs, including the financial contribution and ROI. These forces have challenged old ways of defining program success.

### Program Failures

Almost every organization has undertaken unsuccessful programs—programs that go astray, costing far too much and failing to deliver on promises. Program disasters occur in business organizations and in government and nonprofit organizations. Some program disasters are legendary. Some are swept into closets or covered up, but they are there, and their numbers are far too large to tolerate (Nickson and Siddons, 2005). The large number of failures has generated increased concerns about measuring project and program success before, during, and after implementation. Many critics suggest that

program failure might be avoided more often if (1) programs are based on a legitimate need; (2) adequate planning is in place at the outset; (3) data are collected throughout the program to confirm that the implementation is on track; (4) an impact study is conducted to detail the program's contribution; and (5) the program's monetary benefits are compared to the program's costs (in other words, ROI is calculated). Unfortunately, sometimes these steps are unintentionally omitted, are not fully understood, or are purposely ignored; to counteract these tendencies, greater emphasis is being placed on processes of accountability. This book shows how these five elements can come together to create value-adding projects and programs.

#### **Increased Total Program Costs**

As the costs of programs and projects continue to rise, their budgets become targets for others who would like to have that money for their own programs. What was once considered a mere cost of doing business is now considered an investment that must be wisely allocated. For example, consider the field of learning and development in the United States. Of course, learning and development programs are necessary in order to introduce new skills and technology to employees, but twenty years ago they were regarded by some company executives as a frivolous expense. These days, the annual direct cost of organizational learning and development is estimated to be over \$100 billion in the United States. A few large organizations spend as much as \$1 billion every year on corporate learning and development. With numbers like these, learning and development is no longer considered a frivolous expense; rather, it is regarded as an investment, and many executives expect a return on that investment.

#### **Trend Toward Greater Accountability**

A consistent and persistent trend in accountability is evident in organizations across the globe: almost every function, process, program, or initiative is judged against higher standards than in the

past. Various functions in organizations are attempting to show their worth by capturing and demonstrating the value they add to the organization. They compete for funds; therefore, they have to show value, including ROI. For example, in many organizations, the research and development function must show its value in monetary terms in order to compete with mainstream processes such as sales and production, which have been showing their value in direct monetary terms for more than a century.

### **Staff Support Managers' New Business Focus**

In the past, managers of many support functions in government, nonprofit, and private-sector organizations had no business experience. Today, things have changed; many managers of support functions have a business background, a formal business education, or a business focus. These managers are more aware of bottom-line issues in their organization and are more knowledgeable about operational and financial concerns. They often take a business approach to their processes, and evaluating ROI is a part of that strategy. Because of their background, they are familiar with the concept of ROI. They have used ROI calculations in their academic studies to evaluate decisions to purchase equipment, build new facilities, or buy a company. As a result, they understand and appreciate the applications of ROI and are eager to apply it in their own operations.

Support functions are often regarded as overhead, a burden on the organization, and an unnecessary expense. These days, the approach of many managers is to outsource, automate, or eliminate overhead operations. Great strides have been made in all three approaches. Consequently, staff support departments must prove their value in order to be accepted as viable support functions or administrative processes, and this proof often includes ROI calculations on major programs.

### **Evidence-Based or Fact-Based Management**

In recent years, there has been an important trend toward fact-based or evidence-based management. Traditionally, many key decisions

were based on instinct and gut feelings; now, more managers are using sophisticated, detailed processes to show the value of their projects and programs. Quality decisions must be based on more than gut feelings experienced in the blink of an eye. With a comprehensive set of measures, including financial ROI, better organizational decisions about people, products, programs, and processes are possible.

When taken seriously, evidence-based management can change how a manager thinks and acts. It is a way of seeing the world and thinking about the craft of management. Evidence-based management proceeds from the premise that using better, deeper logic and facts to the extent possible helps leaders do their jobs better. It is based on the belief that facing the hard facts about what works and what doesn't work and understanding and rejecting the total nonsense that often passes for sound advice will help organizations perform better (Pfeffer and Sutton, 2006). Moving to fact-based management makes it easier to expand performance measurement to include ROI calculations.

### **Limitations of Benchmarking**

Many managers have been obsessed with benchmarking, using it to compare every type of process, function, and activity. Unfortunately, benchmarking has its limitations. First, best practices are sometimes elusive. Not all participants in a benchmarking program or report necessarily employ the best practices. In fact, just the opposite may be true: many benchmarking studies are developed by organizations that are willing to pay to participate. Second, what is needed by one organization is not always needed by another. A specific benchmarked measure or process may be of limited use in actual practice. Finally, benchmarking data are often devoid of financial information, reflecting few measures of actual financial contributions. Therefore, many managers are now asking for more specific internal processes that can evaluate those important financial measures.

### **Executive Appetite for Evaluation of ROI**

Evaluation of monetary contribution and ROI is receiving increased interest in the executive suite. Top managers who have watched budgets continue to grow without the implementation of appropriate accountability measures are frustrated, and they are responding to the situation by turning to ROI assessment. Top executives now demand ROI calculations and proof of monetary contributions from departments and functions that previously were not required to provide them. For years, function managers and department heads convinced executives that their processes could not be measured and that the value of their activities should be taken at face value. Executives no longer buy that argument; they demand the same accountability from these functions as they do from the sales and production units of the organization. Such demands for accountability require organizations to shift their measurement processes to include the evaluation of financial impact and ROI.

### **Why Forecast ROI?**

Although ROI calculations based on post-program data are the most accurate, sometimes it is important to forecast ROI before a program is initiated or before final results are tabulated. Several critical issues drive the need for a forecast before a program is completed or perhaps even before a program is pursued.

### **Expensive Programs and Projects**

Because forecasting reduces uncertainty, it may be especially appropriate for costly programs. In these cases, implementation is not practical until the program has been analyzed to determine the potential ROI. For example, if a program involves a significant amount of effort in design, development, and implementation, a client may not even want to expend the resources for a pilot test unless some assurance of a positive ROI can be given. In another example, an

expensive equipment purchase may be needed in order to launch a program. It may be necessary to forecast ROI prior to making the purchase, to ensure that the monetary value of the process outcomes outweighs the costs of equipment and implementation.

While there may be trade-offs in deploying a lower-profile, lower-cost pilot, the pre-program ROI is still important, prompting some clients to stand firm until an ROI forecast is produced.

### **High Risks and Uncertainty**

Sponsors want to remove as much uncertainty as possible from the program and act on the best data available. This concern sometimes pushes the program team to forecast ROI before any resources are expended to design and implement the program. Some programs are high-risk opportunities or solutions. In addition to being expensive, they may represent critical initiatives that can make or break an organization. Or the situation may be one in which failure would be disastrous and there is only one chance to get it right. In these cases, the decision maker must have the best possible data, and the best possible data often include an ROI forecast.

For example, one large restaurant chain developed an unfortunate reputation for racial insensitivity and discrimination. The fallout brought many lawsuits and caused a public relations nightmare. The company undertook a major program to transform the organization, changing its image, attitudes, and actions. Because of the program's high stakes and critical nature, company executives requested a forecast before pursuing the program. They needed to know not only whether this major program would be worthwhile financially but also what specifically would change and how specifically the program would unfold. This analysis required a comprehensive forecast involving various levels of data, including the ROI.

### **Post-Program Comparison**

An important reason for forecasting ROI is to see how well the forecast holds up under the scrutiny of post-program analysis. Whenever

a plan is in place to collect data on a program's success, comparing actual results with pre-program expectations is helpful. In an ideal world, a forecast ROI would have a defined relationship with the actual ROI, or, at least, one would lead to the other, after adjustments. The forecast is often an inexpensive process because it involves estimates and assumptions. If the forecast becomes a reliable predictor of the post-program analysis, then the forecast ROI might substitute for the actual ROI. This could save money on post-program analysis.

### **Compliance**

More than ever, organizations are requiring a forecast ROI before they undertake major programs. For example, one organization requires any program with a budget exceeding \$500,000 to have a forecast ROI before it can receive program approval. Some units of government have enacted legislation that requires program forecasts. With increasing frequency, formal policy and legal structures are reasons for developing ROI forecasts. All of these reasons are leading more organizations to develop ROI forecasts so that their sponsors will have an estimate of programs' expected payoff.

### **Final Thoughts**

This brief introductory chapter describes the rationale for tackling the key issues in this book. It shows why costs must be developed and reported on a routine basis for reasons other than the ROI calculation. This chapter also discusses the importance of measuring ROI and why ROI is evolving into a principal measurement requirement. In addition, this chapter explains when it is important to look into the future and forecast the ROI of a program before it is initiated. The next chapters will amplify these areas in much more detail.

## References

- Nickson, D., and Siddons, S. *Project Disasters and How to Survive Them*. London: Kogan Page, 2005.
- Pfeffer, J., and Sutton, R. *Hard Facts, Dangerous Half-Truths and Total Nonsense: Profiting from Evidence-Based Management*. Boston: Harvard Business School Press, 2006.

