

How to calculate Return on Investment

One of the most common reasons to calculate return on investment is to validate a proposal's potential cost savings. However, it's also a useful tool to measure the impact of projects that support company strategies to improve productivity, IT infrastructure, competitive positioning, or reduce environmental impact.

To calculate a proposal's return on investment (ROI), add up the value of its benefits and subtract its costs. In most cases, you'll also need to account for the time required for the improvement to pay for itself. A payback of three years or less is a generally considered worthwhile.

The more complex the proposal, the more difficult it is to calculate ROI accurately. The tips offered here are intended for small or moderately-sized proposals. For larger scale proposals, enlist the aid of a financial analyst or other accounting expert to accurately calculate your project's ROI.

ROI Formulas

ROI can be expressed in a simple formula:

$$\frac{\text{Benefits} - \text{Costs}}{\text{Costs}} = \text{ROI}$$

To calculate the payback period, divide the Costs by the Benefits, for example:

\$1000 (Costs) / \$3000 (Benefits) = 0.33 of a year = about 4 months or

\$1000 (Costs) / \$300 (Benefits) = 3.33 years = 3 years, 4 months



Calculating Benefits

How will the proposal benefit your company or department? Common project benefits include one or more of the following:

- Cost reduction
- Productivity increases
- Process improvements
- Waste reduction

To calculate the benefits of a proposal use this simple formula:

$$\text{Current Cost} - \text{Cost after Change} = \text{Benefits}$$

If quantifying your current costs is too difficult you may be able to use industry averages. If your proposal involves a supplier, consider enlisting their help in calculating your ROI. If they'll provide a reference you may even be able to discuss the actual ROI with one of their customers.

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Calculating Costs

The cost of your proposal will either be a one-time expense or an ongoing cost. The cost may involve multiple considerations. Start with the obvious ones—and those with measurable hard dollar costs:

- Number of people involved
- Labor rates and estimated hours
- Consulting fees
- Training costs
- Other costs—hardware, software, supplies, etc.

When quantifying a complex process, break it into distinct steps. Map out the workflow to ensure you capture the entire process and the dependencies required for each step.

When you and your team have agreed you've accurately captured the hard dollar costs, consider soft dollar factors which might affect your costs. For example, will those affected embrace the change or resist it? Payback periods will be lengthened if employees aren't onboard or if the learning curve is difficult.

Factors outside ROI

Be sure to consider factors beyond the numbers. How will the proposal affect employees, suppliers, prospects, and customers? Non-financial impacts include:

- Attitude
- Morale
- Image
- Ease of use
- Environment
- Satisfaction
- Retention

When evaluating a proposal or project, understanding ROI is a key consideration. Understanding ROI will help you make decisions with positive financial benefits and keep your business moving forward.



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