Three Ways to Factor Risk into the Decision to Fund a Project [1]

Part II: Benefit Risk [2]

By Fernando Santiago

Covid-19 has shown us how volatile external assumptions can be in estimating project benefits. In part II of the article "Three ways to factor risk into the decision of funding a project", Fernando Santiago presents concrete strategies for managing uncertainty in project benefits.

In the first installment of this three-part series[3] we saw that, while risk is usually included as reference information in business cases, it is seldom used to adjust the calculation of value and financials (IRR, NPV), both from the investment and benefits side. In this second installment, we will concentrate on benefit risk and how external factors, out of control of the organization, are the basis of the estimation of benefits. In these times of unprecedented uncertainty caused by Covid-19, assumptions related to the economy and market conditions, likely used in business cases, have to be re-assessed. This article also covers business risk and how it should be considered when assessing a project for approval.

Benefit risk

If there is uncertainty in calculating delivery risk, benefit risk usually has higher uncertainty, as the estimate of benefits is based on factors like the state of the economy and the market, competitor moves and other factors that cannot be controlled by the organization. In addition, when it comes to making a business case attractive, benefits are easier to stretch than investment, and many times benefits get grossly exaggerated just to get the numbers and the proposal approved.

The impact of Covid-19 on the economy and markets is a risk that, while it existed and was identified by many brilliant minds, it would be rare to find in the assessment of investment for projects. For the majority of industries, it came completely unexpected. In risk management we usually talk about those risks that have a very low probability but a

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[1]This three-part series is by Fernando Santiago, co-author of the book The Outcome-Driven Organization and Managing Director of P3M Solutions, a Canadian corporation specialized in benefits realization management that provides consulting and training in project, program, and portfolio management (P3M). See his profile at the end of this article.

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[3] Santiago, F. (2020). Three Ways to Factor Risk into the Decision to Fund a Project – Part I: Delivery Risk. *PM World Journal*, Vol. IX, Issue VIII, August. Available online at https://pmworldlibrary.net/wp-content/uploads/2020/07/pmwj96-Aug2020-Santiago-factoring-risk-in-project-funding-part-1.pdf

huge impact if they happen. An outrageous and unlikely example is a tsunami hitting a nuclear plant; well, it already happened in Fukushima, Japan, 2011. Now the whole world got hit by Covid-19.

We will, at some point, get back to some form of normalcy, when we will assess new projects for investment again. The assessment of benefit risk should follow a similar approach than the one presented in the first installment of this series for delivery risk: assess the project against a list of pre-defined sources of risk. For benefit risk, sources are expected economic growth, interest rates, exchange rates, competitor moves, regulation, etc. When it comes to development of an innovative product, the assumption of being first to market is many times the basis of the estimate. The question is how do we know that competitors will not get there first? Assumptions must be based on facts. Following the example: "competitor X already has the infrastructure needed, and our organization doesn't," the assumption of being first to market is an unlikely scenario.

There are three estimates to consider when it comes to assessing the impact on benefit risk:

- The estimate of yearly benefits (i.e. how many widgets we think we will sell, at what price and profit margin.)
- The window to realize benefits: once it starts, how many years is reasonable to expect
- The contour for each one of the years, including the initial growth and final decline

The three estimates above are impacted by uncertainty, both external and internal to the organization. If we are selling products that are discretionary (i.e. designer handbags), the state of the economy, employment and inflation are strong factors. Needless to say, competitor moves, new entrants and substitute products come into place and, yes, Papa Porter is very much alive. When most of our markets or suppliers are overseas, exchange rates are fundamental.

As explained for delivery risk, the assessment should be based on pre-defined sources of risk, in order to define whether a project has a high/medium/low benefit risk and how the estimates should be adjusted to define a most-likely scenario that factors risk.

Business Risk

Projects are intended to impact the business in a positive way; however, they could also have a negative impact. Business risk from a project is usually assessed in terms of operational, financial, strategic, reputation and legal/compliance risks. At each organization, governance should define how and when this assessment is performed in the life cycle of the project. A good practice is to assess business risk no later than the business case level. At that point, if there is even a small probability that the proposed project could impact the business, the project could be required to define a plan to mitigate the risk, and include it in the project schedule and budget. Even with a solid mitigation plan, a project could be cancelled or modified to avoid business risk altogether.

Business risk becomes, for the most part, a binary decision. Even if mitigation is in place, a scenario that considers the full impact of the identified business risk should be part of the estimation of benefits. The estimate of dis-benefits becomes essential. When a risk realizes, probability is no longer a factor and the risk has the full expected impact. Because of this, in many cases, governance defines business risk as a pre-condition, and not part of the criteria to approve a project.

Conclusion

Whether it is benefit, business or delivery risk, when deciding to invest money into a proposed project, the assessment of risk cannot be a comment or supporting information in the business case. Not factoring risk into the estimates of delivery and benefits is simply irresponsible, as it would present the investor an optimistic assessment of the project. Just consider this: would you fund a project with your own money without factoring risk?

About the Author

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Fernando Santiago, PMP has been a pioneer and innovator on the topic of benefits realization management for more than ten years. He is co-author of the book The Outcome-Driven Organization, as well as several white papers and articles, presentations and webinars. He has also developed original tools and a software application for benefits realizations management. He has worked in financial institutions, energy and technology companies, as well as educational and professional institutions in North America, South America, Asia and Europe. Fernando is a practitioner, consultant and trainer. He is an international public speaker and invited professor at the MBA level. Based in Ontario, Canada, Fernando can be contacted at fsantiago@p3msolutions.org