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

Part III: The acid test for a business case [2]

By Fernando Santiago

Covid-19 has shown us how volatile external as well as internal assumptions can be in estimating project benefits. In part III of the article "Three ways to factor risk into the decision of funding a project," concrete strategies are presented for compounding delivery and benefit risk, not only in terms of time and cost, but also in terms of quality/fitness for use, the perception of value from the point of view of the beholder: the "acid test" for a business case.

In the first installments of this three-part series 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. This is particularly relevant in these times of unprecedented uncertainty caused by Covid-19. In this third installment, we present a concrete approach to compound the impact of delivery risk and benefit risk. Furthermore, we discuss the impact of quality, focusing on fitness for use.

As discussed in the first installment, delivery risk not only increases the time and cost for the project but can also impact the window for the realization of benefits, even to a point when benefits may not be realized at all (the hot-dog stand at the Olympics or the first to market assumption). We have all heard the story of the sponsor that tells the project manager: "you have delivered exactly what I asked, but..."

There is another way in which delivery risk can impact benefits, which is frequently overlooked, and that is fitness for use: does the product do what it is supposed to do? This is not functionality or requirements, which can be tested and fixed before the output is delivered. Fitness for use is more on the side of the perception of the customer. The best example I have found to understand this concept is the purchase of a dishwasher: when you go to the store you do not ask the salesperson if the appliance you are considering will leave the dishes clean; this is assumed. Requirements for a dishwasher are dimensions, finishing, cycles, etc. However, after it gets installed at home you run 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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first batch and, once it's done, someone, likely the wife in the household, will pull one glass and put it against a light to see if there are spots on it or not. This is fitness for use; of course, it washes dishes, but does it leave them the way I expect?

Fitness for use is a condition for the realization of benefits and could have a major impact, even reducing benefits to a minimum or even zero. Value is in the eyes of the beholder and, if customer value is not realized, the product will not deliver the expected benefits, period. Perception of value from the customer not only depends on what you deliver but also on external factors. Today we think that Netflix will never be dethroned, but reel back to Blockbuster, then the DVD; both succumbed to the next technology. Substitute products are not the only threats, but also competitors and new entrants, who can offer better fitness for use, lower price, or both. How many widgets you sell, and how much you can charge, will depend on the customer's perception of value.

The impact of delivery risk and benefit risk should be compounded to generate a scenario, maybe pessimistic, but one that cannot be ignored when making a decision to invest. Both streams of cashflows, investment, and benefits, need to be adjusted to reflect risk, not only in terms of amounts but in terms of time. The financial concept of value comes in full display here: benefits minus investment, adjusted to risk, and to the time value of money.

Delivery risk, as it is mostly internal, can be mitigated. An example of this is, to mitigate uncertainly on whether two technologies can be integrated, you can have an initial exploratory project, a proof of concept, to determine whether the intended product is doable or not. Another option is to hire expert advice; this can be perceived as expensive, but when you compare it to the cost of a failed project, it looks like pocket change. When it comes to benefit risk, mitigation is more difficult or impossible, as it is mostly based on assumptions on external factors.

Higher investment than planned and lower benefits than expected are the acid test for a business case. An investment proposal that has high delivery risk and high benefit risk should not, in theory, be funded, unless the expected returns are strong, even after factoring risk, and/or is critical to the company strategy. These are the bold and hairy decisions that, sometimes, determine the success or failure of an organization.

Whether it is delivery or benefit risk, or the acid test that combines them, the decision to invest money into a proposed project should be based on financials that factor risk. Risk cannot be reference information on a business case but reflected with hard numbers. Not doing so is simply irresponsible, as it would present the investor an optimistic or, best case, a most-likely assessment of the project. Just consider this: would you fund a project with your own money without factoring risk?

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