White Paper 2013-07

How to Implement the Specific Approaches Required for the Due Diligence of Project Organization

Due diligence to appreciate the value of an organization (before an acquisition, for example) is a specialty generally driven by finance specialists. However in the case of project-driven organizations, conventional financial analysis cannot easily reflect the actual situation of the organization and what can be expected to happen. Project Value Delivery's expertise and experience is shared in this White Paper which includes practices and tools to improve the reliability of these due diligences.

The limits of conventional approaches of due diligence for project organizations

Conventional due diligence is appropriate to determine the value of assets, analyse the overall balance sheet, cash flow generation and other financial indicators of most organizations. One key component of due diligence, beyond the measurement of the current condition of the organization, is to give an idea of what can be expected from it in the short and medium term. In that respect, due diligence generally fails to apprehend the complication of project-based organizations or interpret correctly the actual business model parameters. This leads to inappropriate accounting for contingencies, estimates of forecast cash flows or consideration of intrinsic risk factors. Results are then inappropriately anticipated and that can significantly change the value of an organization, if it is measured for example, typically, by valuing the expected cash flow in the following months or years.

Because of the fact that projects are one-off endeavours, usual approaches used for manufacturing companies cannot be used for due diligence of project organizations

The characteristics of project-driven organizations that do not respond to the usual due diligence model include:

- The future is not a reproduction of the past (projects are unique endeavours with different maturity phases);
- Commitments already done on the basis of inaccurate estimates will bear consequences over several years with limited recovery possible;
- Project forecast is over the project cycle, which can span over several years, while timing of income and expenditures might slip from one accounting period to the other independently;
- The risks of project execution can be possibly massive, on the order of magnitude of their budgets; or projects can simply results in assets producing much less than expected;
- Project-driven organization's own assets are generally project-enabling, i.e. they bear an intrinsic leverage that depends on the project types. Their value is thus not just the reselling value, but the capability to generate cash by leveraging on them through project management activities.

First step – check the adequateness of the Cost Control approach

Notwithstanding good practice on the matter, it is still astounding how many project organizations still control their costs based on the invoices they receive and not through their commitments for the future and a detailed understanding of the activities that take place at present. Because of the delays in invoicing, invoicing-based control gives only an image of the project expenditures from a few weeks to a few months ago. Cost control should be based on commitments to give an accurate, timely picture.

Should the organization actually base its control on invoicing, with a low commitment control and follow-up, risks are high that surprises will arise, in particular for subcontracts in the engineering, operations and logistics areas. Some projects executed in remote corners of the world have suffered dozen of millions $ of surprise costs for logistics and other local services that had not been accounted for when they were committed. An unambiguous practices for authorization and recording of commitments is a must.

A particular effort needs to be done in the case of poor commitment tracking to understand what is the amount of risk which is unaccounted for, and add-it to the cost base of the project to determine its actual expectations.

An other important check is to check that Change Orders are not recognized as revenue before they are signed. If they would be, this would show that there is a strong possibility of overstatement of actual results by the company (and poor governance).

Finally, it needs to be clear whether overhead, financing and commercial costs, and in what amount, are charged to the project, to assess project performance out with overhead charges. It can be tricky sometimes as some overheads can be hidden in the usage rates of internal resources. This depends on the company cost control philosophy, and is important to be understood so as to evaluate the overall company picture.

Second step – Check the quality of the Project Controls processes

Project Controls processes, which combine cost control, schedule control and risk management, as well as Change management, need to be assessed as to whether they

actually reflect the actual condition of the project. This can be quite easily evaluated by interviewing people in the field and checking with them that their understanding of the project schedule/ cost is consistent with what is reflected in the project master schedule/ cost model. A quick check on the update and reporting process and whether previous projects have shown last minute surprises in the field of cost will also give quite a good idea of the quality of these processes.

Proper Project Controls should add to a deterministic and prudent forecast, a range of sensitivities (both in schedule and cost) that can be used to give a bracket to the final expected project outcome.

Should the quality of the Project Controls process appear to be sub-standard, a significant effort is needed to create an accurate picture of the actual situation of the project and of its actual progress rate.

Third step – Check the actual project performance and extrapolate the possible outcome

As detailed in White Paper 2013-09, a general rule of thumb can be applied to delays or cost overruns. The final delay / cost overrun can often be expected to be twice to three times what is currently being observed (compared to the baseline), while this will not be reflected in the forecast numbers produced by the company. Thus, a project running late, without a proper explanation and realistic recovery plan, is susceptible to incur significant further additional loss and delays, doubling or tripling the observed cost overrun and delay. These additional costs and delays need to be factored in to establish a realistic expected outcome (on the other hand, contingencies should be subtracted to the estimated additional degradation as they are supposed to be there to cover such cases).

A particular issue is that delays will impact the actual revenue, the revenue recognition and cost at the end of the accounting periods even if the revenue and cost forecast is not affected. This needs to be taken into account in predicting upcoming Cash Flow and Profit & Loss.

Fourth step – Evaluate actual expected cash flow of current projects

Provided that the three first checks have been positive, the numbers crunched by the project cost control proven to be trustworthy, it is quite straightforward to estimate the incoming cash flow and future P&L per accounting period from current projects.

- Cash flow depends on the actual current billing and expected costs, and the timing of possible Change Orders
- P&L by accounting period depend on the Percentage of Completion (POC) measured on the cost spent at the end of each accounting period, and the forecast of the final project result (as amended by step 3)

These results can then be rolled up at the organizational level across the project portfolio.

Fifth Step – Add-on the treatment of assets

Some companies have expensive tangible assets that they leverage for their projects. Other companies have mainly people as their main asset. The commercial driver of project award needs to be fully understood. Asset utilization is a key factor that needs to be ascertained to estimate if the organization is stretching itself or, if there are risks of losses from asset underutilization.

Conclusion: How to do a proper due diligence for project-based organizations

Because of the fact that projects are one-off endeavours, usual approaches used for manufacturing companies cannot be used for due diligence of project organizations. The insights of experienced specialists in project management and project controls are needed to give the right understanding of the opportunities and risks of the organization being analysed, which often can be extremely significant both ways, changing fundamentally the perceived and actual value of the organization under scrutiny.

The actual final valuation can be quite different from the rosy picture shown by conventional accounting!

Depending on the situation, more or less data and more or less access to the organization's personnel is available. The due diligence process needs to be tailored to the possible information obtainable; however a lot of information can already be gathered from the internal project reporting (including whether the project controls process has the required quality). It will allow to give a useful sensitivity bracket for expected value that can then be further refined through targeted inquiry and sampling.

Proper due diligence of project-driven organizations should not be underestimated. There are many examples of poor decision-making in the area of project-driven organizations' acquisitions conducted without a proper understanding of the issues at stake – and the actual final valuation can be quite different from the rosy picture shown by conventional accounting!

Project Value Delivery has experience in due diligence for project-driven organizations. Contact us for more information.

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