

Financial Management in Major Project Businesses: an MPA Seminar held at the Institution of Civil Engineers, London on 24 June 2004

Participants

More than 65 participants attended the seminar and the following organizations were represented:

Arup, Atkins Ltd, BAA Plc, Balfour Beatty Plc, Bechtel Ltd, Bovis Lend Lease, Crossrail, CSE International, Electronic Data Systems Ltd, Emcor Rail Ltd, Erasmus University Rotterdam, Halcrow, Henley Management College, Herbert Smith, IBM Business Consulting, ING Group, Intrepid Energy North Sea Ltd, Kellogg Brown & Root, KPMG, Lockheed Martin, Mott MacDonald, MTR Corporation, Murray & Roberts Ltd, Network Rail, Office of Government Commerce, PA Consulting Group, Rolls-Royce Naval Marine, Rolls-Royce Plc, Sir Robert McAlpine Ltd, Strategic Rail Authority, Taylor Woodrow Construction, Thales UK Plc, The Nichols Group Ltd, Transport for London, UK Trade & Investment, UKAEA

New accounting standard

International Accounting Standard No 11, Construction Contracts, takes effect in 2005 and applies to listed companies.

Under the new standard:

- revenue and profit are recognized differently, and the total revenues and expenses of the contract that are put into the profit calculation must be capable of reliable measurement
- the concept of fair value accounting will be strengthened, with some assets and liabilities having to be revalued at their year-end market value and not at their original historical cost
- where assets are negotiated separately, separate contracts are required
- there is a greater emphasis on the legal form of a joint venture
- embedded derivatives (i.e. the foreign-exchange element of an overseas construction contract) have to be accounted for separately
- there is a new approach to pensions accounting, with pension scheme assets likely to become more volatile.

Those who are making the transition to the new regime warn that it is a tortuous exercise. But there are benefits ahead: consistency right across the EU, greater transparency and increased awareness of hidden liabilities.

The financial management of major project businesses is undergoing a quiet revolution. First and foremost—and certainly inescapable for any listed company—is the introduction of a new international accounting standard in 2005. The financial shape of a project business will look very different in the future.

The industry context of major projects has also changed significantly in the last decade. In construction, contractors have extended their involvement in projects under PPP/PFI arrangements. In the IT services sector, suppliers are making greater upfront investment to meet client needs in the short term in order to secure profitable ongoing business in the longer term. Elsewhere, contractors are seeking to make themselves attractive to City analysts and fund managers—not an easy task in an industry characterized by risk and uncertainty. With so much change around, robust financial management is needed as never before.

MPA Seminar 113 analysed the background and presented its strategic and practical recommendations.

Background

Major projects have to be delivered successfully against a complex and volatile background, sometimes with sector-specific requirements:

- high bidding costs
- uneven flow of projects
- short life-span of assets in the IT sector—regular “refreshes” essential
- substantial upfront costs generally, including project development.

Changing context of major projects

The context of major projects has been evolving gradually:

- through PPP/PFI, contractors are getting involved for the long term
- the volatility in the IT sector means that companies are sweetening prospective clients with offers of upfront investment
- because of economic downturn, some sectors (telecoms, IT, power) are deferring capital expenditure, with knock-on effects for their supply chains
- a new international accounting standard is introducing new requirements.

Protecting the financial health of your organization

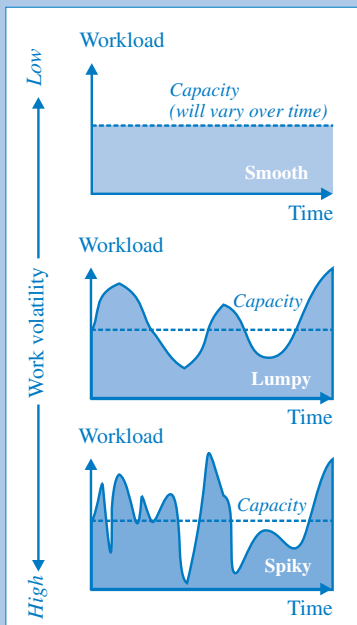
To maintain control in these changing times:

- understand the content and repercussions of the new accounting standard (see box)
- maintain a rigorous regime for monitoring all live projects within the organization – on a global level if need be
- cultivate the investment community and reduce your exposure to economic swings through a cautious spread of projects in a balanced portfolio
- educate City analysts on the realities and benefits of non-recourse funding (not an easy task as project finance is not always well understood)

MPA events are confidential, although this summary has been compiled so as not to breach confidentiality. Full proceedings and entry to MPA events are available only to members.

Workload profiles

In a major project business, the workload is often uneven. Three patterns of workload have been identified: smooth, lumpy and spiky. It is fairly easy to manage a business with a smooth profile. Spiky workloads may be the result of taking on a few large contracts, but the most common pattern for project businesses is the lumpy workload profile. This demands rigorous resource management, and the ability to subcontract and draw on other resources internally may help.



- leverage the benefits of long-term contracts: new processes and innovation used on one contract can be applied on the next
- maintain transparent processes so that it is clear to all where value is being created and where there is underperformance
- consider the advantages of a matrix-type business, i.e. taking people from right across the business to put them on to a particular project.

If the worst happens...

If your business is in trouble, stabilize the company through:

- operational measures: take short-term steps such as cost cutting and redundancies
- financial measures: realize cash and monitor cashflow carefully
- management measures: recognize changing priorities and make new appointments at the top if you have to.

Harnessing the right tools

Tools of good financial management include:

- a transparent information system and weekly reporting
- devices to give warning signs of trouble, e.g. the “dashboard” system
- the m-cubed rule, a formula used to calculate profit recognition—it works well for some
- earned value—seasoned project practitioners see this as the best tool around, though there are plenty of sceptics.

And finally, six key questions to ask...

- Am I watching the financial health of my contractors and suppliers properly?
- Am I properly briefed about the 2005 accounting revolution?
- Am I really aware of investor views on the performance of my business?
- Am I watching the cashflow in my business to check my commercial health?
- Am I controlling the length and complexity of the bidding process in order to control costs?
- Do I have a system to measure the financial health of business regularly and clearly?

The four stages of the industrial cycle

The industrial cycle of a company has been defined as having four stages. The first is rise and fall, which are linked together under this model. The second is stabilizing a business in decline. The third and the fourth stages are keeping the show in the road, and delivering value again. Stabilization is a crucial part as the business tries to arrest a rapid decline.

