WESTNEY ADVISOR

Due Diligence for Improved Project Predictability

November 2009

A Call for Change

As capital – intensive industries worldwide examine their project portfolios, new priorities are being placed on risk management. Recent surveys by the McKinsey Global Institute[1] and CFO Research Services[2] indicate three imperatives for CFOs today: strengthen risk management, improve forecasting capabilities, and optimize cash-flow. COSO (The Committee of Sponsoring Organizations of the Treadway Commission), agrees, stating in a recent report[3]: *In the aftermath of the financial crisis, executives and their boards realize that ad-hoc risk management is no longer tolerable and that current practices may be inadequate.*

These priorities are directly applicable to the investment decisions and management of capital projects as illustrated by Figure 1 below.

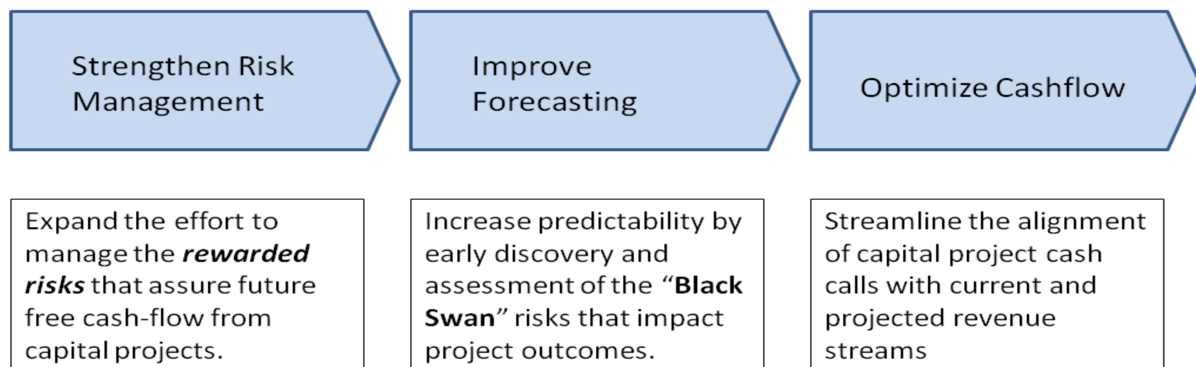

Figure 1: In addition to improving the predictability of project outcomes, a new approach to risk management can provide the basis for improved forecasting, reduced cost and optimization of cash-flow.

What does this new, stronger approach to risk management look like? We might describe the conventional approach as Risk Management version 1.0, what is needed is an upgrade to Risk Management (RM) 2.0[4].

Needed: Risk Management 2.0

A consensus is emerging around the essential requirements of "Risk Management (RM) 2.0". If project predictability is to be improved, RM 2.0 must reverse current practices by:

- Taking a holistic, multi-dimensional view of risk, looking across the organization's business, operational, and financial functions as well as a wide view of threats, trends, and risk drivers from external sources[4]
- Replacing historical data-driven statistical analysis with an increased focus on unknown risks, applying stress testing and scenario analysis where the most severe risks reside yet data is scarce[5]
- Moving from an emphasis on managing unrewarded, compliance-driven risks to a focus on rewarded risks, like investments in capital projects, which add value[6]
- Developing explicit links between business performance and risk management[7]

To meet these requirements, RM 2.0 must focus on improving predictability by turning "unknown – unknowns" into "knowable – unknowns" (see Figure 2 below).

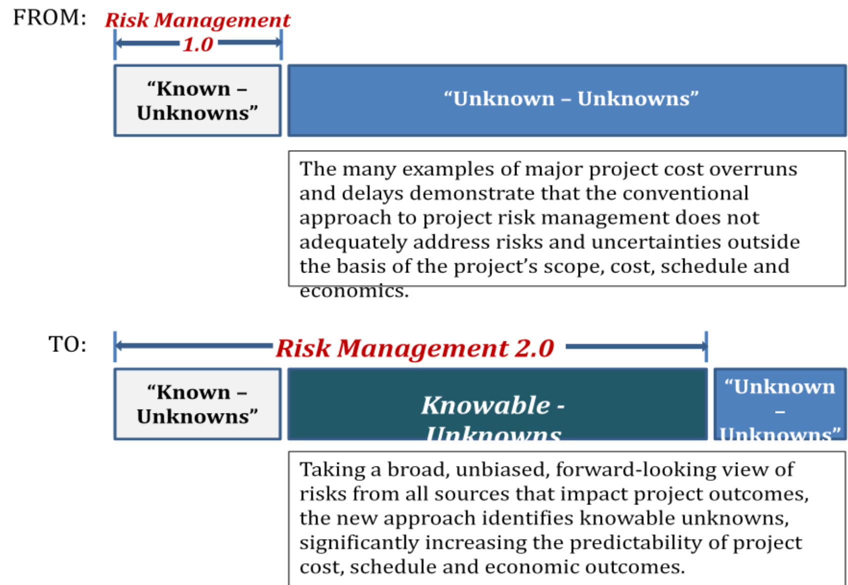

Figure 2: The well-documented tendency of large capital projects to experience significant cost overruns and schedule delays can be attributed to the limitations of conventional risk management.

Capital Project Due Diligence provides the basis for implementing Risk Management 2.0

Given the criticality and risks associated with CapEx decisions, there is a surprising inconsistency between the due diligence required for capital project investment decisions and that routinely provided when considering mergers & acquisitions (M&A). While few executives would make an M&A decision without independent, expert due diligence, most organizations have relied on internal work processes and reviews for capital project investment decisions even when the magnitude of such investments is similar to that of M&A.

Capital Project Due Diligence corrects this inconsistency.

To meet the requirements of RM 2.0, Capital Project Due Diligence addresses the 5 Forces of Project Predictability, identifying known – unknowns as illustrated by Figure 3 below.

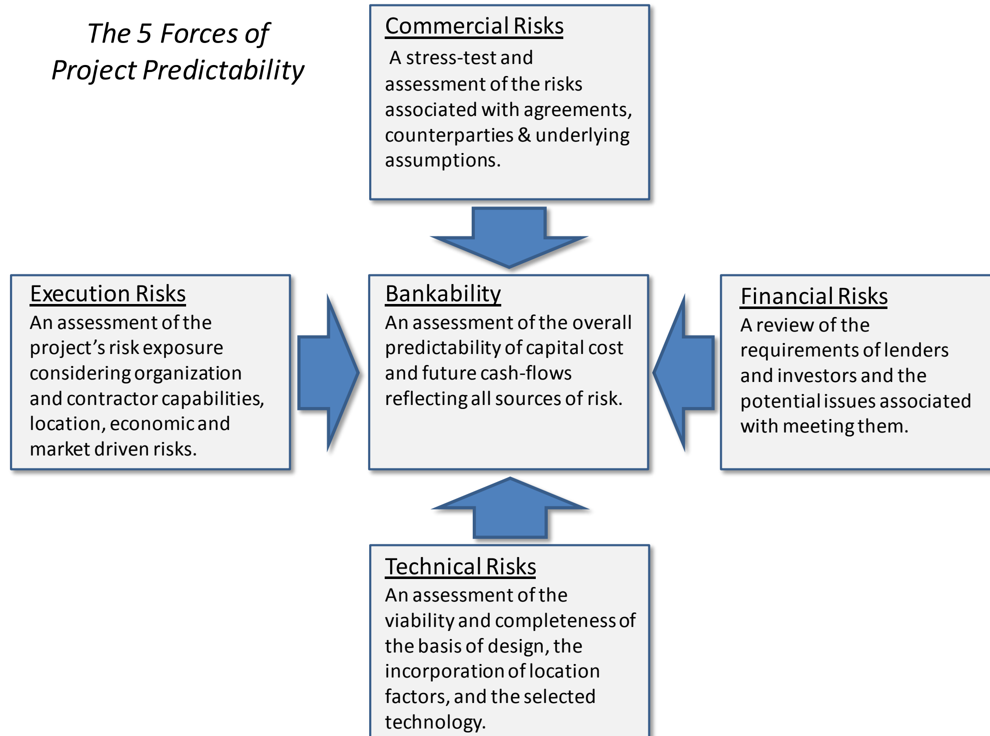

Figure 3: Due Diligence facilitates Risk Management 2.0 for capital projects, considering all the forces of predictability and allowing capital investment decisions to be based on bankability

Capital Project Due Diligence brings the CapEx decision-maker the improvements in risk management, forecasting and cash-flow optimization needed to meet stakeholder objectives for project predictability.

References:

1. *How Finance Departments are Changing,* The McKinsey Quarterly, 3Q2009.
2. *Driving Profitability in Turbulent Times with Agile Planning and Forecasting*, CFO Research Services, May 2009
3. *Effective Enterprise Risk Oversight – the Role of the Board of Directors*, 2009 report by The Committee of Sponsoring Organizations of the Treadway Commission (COSO): The American Accounting Association, The American Institute of Certified Public Accountants, Financial Executives International, The Institute of Management Accountants, and The Institute of Internal Auditors
4. *Rethinking Risk Management: Why the Mindset Matters More Than the Model*, Knowledge @ Wharton, April 2009; the term "Risk Management 2.0" is attributed to Erwann Michel-Kerjan, Managing Director of Wharton's Risk Management & Decision Processes Center.
5. *The New Role of Risk Management: Rebuilding the Model,* Knowledge @ Wharton, June 2009
6. *Breathing Lessons: How CFOs can thrive under pressure,* Deloitte Development LLC, 2007
7. *Seizing Opportunity: Linking risk and performance,* PriceWaterhouseCoopers, July 2009