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How to Deal with the Complication of Cost Control for Multi-Entity, Multi-Currency International Projects

Most Large, Complex Projects are executed nowadays in an international environment. Sometimes the contract given to a Contractor is split into several contracts for several entities often located in different countries. At the same time, multiple currencies are often used both for revenue and expenditure. Being able to manage effectively this additional complexity and take advantage of it is a substantial competitive edge for international contractors, where maturity of processes and systems is essential for success. This White Paper explains the basics that need to be followed.

Multi-Entity contracts

For various reasons a Contractor's contract sometimes needs to be split into several contracts. The most common is to split between in-country and out-of-country contracts.

Accounting principles state that several customer contracts may be combined for accounting purposes under certain conditions. This consolidated view needs to be considered carefully: it implies significant provisions to be taken by the different entities involved to account for the overall Project progress, and not just the progress of the Project for each single entity, which would not be sufficiently prudent, for the following reasons:

- The Project profit is generally not equally distributed between all contracting entities; which would possibly lead to a too early overall profit recognition,
- Risk contingency needs to be recognized according to the type of work that is being performed by the entity, for each entity (in terms of both value and time-phasing), and cannot just be managed at the consolidated level,
- There are possibly, as well, inter-contracting entity billings which need to be accounted for at entity level but removed from the consolidated view.

The method is thus to consider the aggregated project situation before recognizing profit, notwithstanding the accounting situation of each individual entity. The accounts of each contracting entity are thus corrected according to the full project overview.

The Project's breakdown structure must hence address the issue of legal entities, with different work packages setup for different entities, both for cost and for revenue: when there are different contracting entities that need to be considered in a consolidated manner for the execution of a single project, the Cost Control function must be still able to produce the required reports showing for each entity, in a time-phased manner, and by currency, what are the actual and the forecast costs and revenue. This is required for proper reconciliation as well as for proper derivation of the substantial accounting provisions that will need to be taken.

Multi-Entity, Multi-Currency Cost Control requires an advanced set of processes and systems and constitutes a significant competitive advantage for mature Project-driven organizations

Multi-Currency Projects

The variability of currency exchange rates is always a concern for all organizations involved in substantial international work on contracts covering long periods. Project-driven organizations are generally not in the business of speculating on currency fluctuations and, on the contrary, try to maintain as much as possible a predictable outcome.

Most organization use hedging to protect themselves against currency fluctuation. There are two sorts of hedging:

- Natural hedging (when the basket of currencies for the revenue is grossly equivalent to the basket of currencies that will be expended as cost)
- Contractual hedging (entering in a contract with a third party to buy or sell a quantity of currency at a certain date in the future at a certain rate, which is close to the current exchange rate plus a fee)

Using natural hedging requires being aware of the following issues:

- In large, complex projects, it might be that the actual costs will be in different currencies that what had been assumed at the tender stage, due e.g. to a different choice of specific suppliers or subcontractors,
- The unavoidable difference in timing between revenue and expenditure, even in a perfectly naturally hedged project, might create significant volatility in accounting because of the requirements to account for "embedded derivatives" if the currencies in question are different from the Reporting Currency.

Due to these difficulties, some project organizations have stopped seeking natural hedging, request for single-currency contracts based on their Reporting Currency, and base their currency protection on comprehensive contractual hedging only.

Using Contractual Hedging is a good protection but still has the following issues:

- Should the expected currency basket of expenditures change (e.g. a different supplier or subcontractor than the base case is finally selected that requires a different currency), the protection afforded by the hedge will not be useful; the same applies if transactions have values different from their budgeted values,

- Because hedges are linked to fixed dates, should the project schedule slip, hedges will mature too early, thereby removing part of the protection afforded,
- Contractual hedging is reserved for significant transaction amounts due to the paperwork involved, and cannot be applied to small transactions.

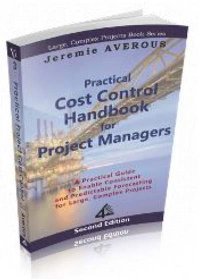
The need for advanced projects and systems

Mature international contractors distinguish themselves by being able to manage the complication of multi-contract, multi-currency situations through adequate systems and processes. This creates additional complexity that needs to be managed by the project manager with the help of the organization’s financial functions so as to be able to draw reasonable advantages of the situation (optimizations) while protecting it against downsides.
It is clear that reaching a stage where organizations can comfortably manage this complexity takes many years of developments and experience that shows in adequate systems and processes. Systems in particular must be tailored to deal with the complications and need to allow access throughout several countries and legal entities, which is sometimes a challenge.

Not mastering Multi-Entity and Currency issues when executing Large Complex Projects can lead to significant surprises for investors and clients

Summary

Multiple contracting entities and multiple currencies are additional challenges that are often unavoidable in the performance of international contracts, in particular in certain countries. Specific control and accounting approaches must be used. If they are not implemented, profit might be recognized imprudently too early and significant impacts can happen from changes in currency exchange rates. This has led many upcoming project-driven organizations in difficult situations with respect to their investors or clients. Surprises created because of these issues denote poor control of project operations.
The Project Manager must be aware of these different possible approaches, make sure that the profit recognition remains prudent and that sufficient protection is provided against currency fluctuations. He must also be aware whether certain constraints on the governance of some contracting entities need to be entertained, as it might impact the actual project execution.



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