White Paper

Margin Erosion: Process Improvements to Help Close the Gap and Deliver a Profitable Project

In the current economic climate, professional service firms are acutely aware of the threat posed by the erosion of profit margins. Without proper planning and monitoring, project margin erosion can sneak up on you gradually. Everything appears to be in order until, suddenly, nothing adds up. And erosion can accelerate quickly.

Margin erosion is a term used to define loss of margin dollars that can occur once a job has been won. More simply, it is a gradual reduction in gross profits over time. Every business has to worry about margin erosion. It can be caused by anything from human error, system error, bad business decisions or practices such as excessive discounting or markdowns, poor quality control or lack of sufficient inventory.

For professional services firms, issues like excessive overhead costs or capital investments ultimately affect profitability; however margin erosion on projects is generally the most significant impact on the bottom line, quickly eating into a company's overall profitability.

Causes of Project Margin Erosion

Many things can erode margins on projects. Some are harder to control than others, but by putting a few processes in place to minimize or eliminate the major areas that give project managers and their teams the most frustration, project costs can be controlled more effectively, and organizations can realize greater financial success on their projects.

There are four primary categories that encompass many of the problems that lead to margin erosion including bad estimates, scope creep, poor resource management and issues with clients. Here are some tips for closing the gaps:

1. Establish repeatable processes for providing accurate cost estimating

Good estimates are the critical first step in assuring that your projects will be successful. However, even under the best of these circumstances, cost estimating is difficult. It requires both quality data and judgment.

In the highly competitive services industry, precise financial information is required for accurate proposals. Knowing and anticipating the project's expenses correctly provides a definitive advantage in the business development process and ultimately, the financial success of the project, particularly on lengthy or large jobs where small discrepancies can have a domino effect throughout the project.

Developing a good cost estimate requires:

- an accurate project scope,
- access to detailed documentation and historical data,
- standard processes and work break down structures to ensure that no portions of the estimate are omitted and to make it easier to make comparisons to similar projects,
- a risk and uncertainty analysis that allows a contingency for unknown costs, and
- an independent review to establish confidence in the estimate

A project's approved cost estimate is a major component in creating a project budget. Because a reasonable budget is essential to a project's efficient and timely execution, a competent estimate is the key foundation of a good budget.

If you are using excel for your estimates, there is a good chance that your project managers are using old rates, inconsistent language, and poor assumptions in their budgets, schedule and project reporting.

2. Proactively manage the change order process

Out-of-scope requests can kill project profits. Every firm gets out-of scope requests from clients, yet few have formal processes for dealing with them. How a firm deals with out-of-scope requests can go a long way in determining a firm's profitability. Change orders are not always a bad thing, but minimizing them should always be a goal.

Change orders usually originate from a few common issues, including:

Miscommunication between the members of the project team – In many ways, clear communication and precise coordination between the client and the project team is the best defense for margin erosion. Putting extra effort in getting the collective project team on the same page early in the project will be rewarded with improved profitability. At the start of every project, care should be taken to schedule regular project meetings, constantly update progress plans, and keep every member of the team updated and informed on the latest developments.

Minimize the effects of change orders on project profitability – Early decisions in the proposal process and initial planning need to be confirmed as the project gets underway. In a good business development process a number of options and approaches are discussed with the client and not everything ends up in the final project scope. Confirming the scope with the client and the team as the project moves through the its various phases assures that if change orders are needed,

Project Margin Erosion:

Common Indicators to Watch For

Costs

- Significant difference between estimated cost to complete and budget for remaining work differ significantly
- Frequent allocation of contingency reserve for newly identified in-scope effort
- Inadequate control of account budgets for remaining work
- Work phases/tasks with no budget left

Schedules

- Unrealistic task durations
- Unrealistic logic and relationships between tasks
- Significant number of activities with constrained start or finish dates
- No correlation between estimate to complete time periods and current project schedule

Data Accuracy

- Project management's reliance on ineffective performance data
- Actual costs exceeding the estimates
- Repetitive reasons for variances

they can be quickly ferretted out before a lot of wasted effort is spent.

Keep scope changes to a minimum - As companies strive to retain clients and obtain new business, project managers and salespeople often accept increases in project scope without fully understanding the financial ramifications of the changes. No matter where they come from, scope changes usually impact the project in terms of both schedule and cost. Reducing and/or eliminating the number of change orders by taking the precautionary steps discussed above at the start of the project.

3. Provide visibility and effective coordination of resources

Teamwork and personal productivity are critical in the services industry. People are a professional services firm's greatest asset. Keeping them busy on the right projects is absolutely critical to your profitability, today. But beyond that, they are critical to keeping your clients happy and the long-term success of your firm.

Improve billable utilization - To improve project margins, project managers must continually focus on increasing employee billable utilization, as well as increase the percentage of billable employees.

Achieve the right project resource mix - The right resource at the right time is critical to both client satisfaction and profitable project delivery, but it can be a balancing act. You must identify and schedule resources in a way that satisfies competing client demands. To address such demands, you need transparent access to

Variance Indicators

The following indicators should be monitored to avoid project margin erosion

Cash Flow Indicator

Cash position = Sum of cash receipts - Sum of cash disbursements

Utilization Indicators

Labor productivity = Actual ours expended/ Earned hours

Realized utilization = Earned hours/2080

Margin Variance Indicators

Forecasted gross margin = Forecasted revenue – Forecasted direct costs

Actual gross margin on closed jobs = Actual revenue of closed jobs – Actual direct costs on closed jobs

WIP gross margin = WIP revenue – WIP direct costs

Unapproved Change Order Variance Indicator

% of margin at risk = Sum of costs incurred on unapproved change orders ($)/Total forecasted gross margin ($)

Schedule Variance Indicator

Schedule variance (%) = Original duration (days) – Revised duration (days)/Total remaining duration (days)

information about your employees and contractors: their work history (including project and client experience), skill sets, availability, and more. Aggregating and analyzing this data can help you staff for project success.

4. Arm yourself with information necessary to proactively respond to cases of margin erosion

Project managers and principals need the tools to budget effectively, closely monitor actual time spent versus budget, adjust their planning based on the required changes and be armed with the information necessary to proactively respond to cases of margin erosion. In order to empower project managers, they must have the appropriate project accounting tools and metrics in their hands and build consistent practices utilizing these tools.

Key Project Performance Indicators

These metrics that should be monitored on a regular basis for all projects. For formulas, please see the side bar on the previous page.

- Cash Position
- Labor Productivity
- Realized Utilization

- Forecasted Gross Margin
- Actual Gross Margin on Closed Projects
- WIP Gross Margin
- % of Margin at Risk
- Schedule Variance %

Accurate Accounting for Time and Expenses - As a project progresses, it is typical for workers to adjust the time spent on a task. A key reason for margin erosion is that the work performed strays from the budgeted time for a task. The inability to recognize this erosion, or gain visibility of the changes, presents significant threat to a project budget. Quick and simple time management across projects and tasks is integral to effective team management.

Summary

The solutions for avoiding project margin erosion all involve a combination of people, processes and tools. When it comes to technology, it is critical for professional firms to have solutions that support the effective collection and analysis of data to provide for better decision making and actionable, strategic reporting and key performance indicators at both the project and firm level. Together, these functions give firms the knowledge they need to achieve their profitability goals.

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