Why Professional Services Organizations Need Improved Financial and Resource Management

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Why Professional Services Organizations Need Improved Financial and Resource Management

Introduction

This white paper addresses the financial and resource management pain points that professional services organizations (PSOs) currently face. It focuses on the benchmarks that PSOs can use to improve their management capabilities and how business applications can help PSOs achieve their goals, including streamlining their businesses, increasing operating margins, and meeting the challenges posed by today's fast-paced global marketplace.

Because the core product of a PSO is the knowledge and skills their people possess, managing and developing their resources pose unique operating challenges. In today's global business environment, the methods used by PSOs to manage and deploy those resources will have a significant impact on their client relationships, growth, and profitability. In addition to resource management, PSOs face multiple internal and external challenges.

PSOs face internal challenges that directly affect how they deliver their services to clients. These challenges include:

- Competition for talent.
- Flexibility in service delivery model.
- Increasingly complex project environment.

The external challenges PSOs face include:

- Increased competition (from foreign and domestic players).
- More educated, sophisticated, and demanding clients.
- Increasingly stringent and constantly evolving government regulations.

These pain points drive the need for PSOs to manage their own resources more effectively, build stronger and deeper relationships with their clients, and still deliver engagements on time and within budget. To achieve growth and profitability, CFOs and partners at small and mid-sized PSOs need scalable and cost-efficient business applications. They also need industry benchmarks and methodologies that can help them run their businesses, reduce costs, and maximize profits.

Business leaders of PSOs need to streamline processes, since this frees them to focus on developing and expanding their businesses. This white paper focuses on three key processes:

(1) Project and resource management
(2) Financial management
(3) Financial reporting

As firms examine these three processes, many are leveraging benchmarks and other operational metrics to measure efficiency and effectiveness. While many of these benchmarks and metrics are not new (such as utilization ratios, day sales outstanding [DSO], and revenue per professional), they are clear indicators of the PSO's performance and can be directly linked to profitability, which will be discussed later in this paper.

This white paper also discusses the success many PSOs currently achieve by leveraging business management solutions to help manage their businesses. Over the past three years, *Consulting* Magazine, Kennedy Information Advisors, and the Bureau of National Affairs (BNA) have seen tremendous advancement in the professional services automation (PSA) market. PSA is software designed for PSOs, such as consultants and accountants. The software is designed to manage both the delivery of client projects and the resources that are required for those projects. Today, PSA software vendors have a better understanding of the challenges PSOs face, and they are incorporating solutions to PSOs' pain points. In the past, PSOs have shied away from leveraging business applications, such as PSA software, because PSOs believed them to be luxuries, not necessities. The evidence in this white paper will clearly show that firms using these applications are more profitable and efficient.

Project and Resource Management

For firms to be profitable in today's market, successful project management is critical. Time and resources can be consumed by wasteful practices, such as poor prioritization, overstaffing or understaffing of projects, or lack of milestones.

Key Challenges

According to the managing director of a $20-million-per-year IT services firm, "Project management is the most important process of running a firm. How you manage your client, their expectations, and your staff on engagements separates the good firms from the bad." In the past five years, PSOs have witnessed a tremendous change in the way engagements are performed. For example, engagements are now more virtual, with fewer team members on site, projects have more milestones built in, and engagement teams consist of more subcontractors. The PSOs' clients have also become more sophisticated about how they purchase professional services, demanding that engagements be performed faster, more cost effectively, and with measurable success. These changes in the industry are forcing firms to address several key pain points:

- Managing costs
- Increasing disperse or virtual engagement teams
- Employing contractors
- Aligning skills and people with client engagements

Managing costs is a critical element for success. The flood of new local and foreign firms that are eager for new business has put pressure on the pricing models of more established firms and has had an adverse effect on their fees and margins. To compete with these foreign and new firms and still maintain margins, established firms must be far more diligent about how they manage costs. In *Consulting* Magazine's global survey of management consultants, *Best Firms to Work For 2008*, almost 14 percent of those surveyed stated that they were not meeting their clients' needs on engagements, and many commented that they had experienced cost overruns in engagements in the past year.

There are two major reasons for this:

- Firms failed to align the correct resources with the project at the proposal stage, and this increased costs later.
- PSOs failed to identify hidden costs in the client engagements.

As clients have become more sophisticated, the costs firms used to pass on to them are now the burden of the PSO. According to Greg Baranszky, managing director of Kennedy Information Advisors, “Large corporations are no longer willing to pick up all the costs with engagements. In 2008, we have seen reimbursement costs associated with engagements drop three percent. While some of that decrease is associated with less travel nowadays in the professional services industry, a lot has to do with clients putting a cap on spending.”

Increasing disperse or virtual engagement teams has resulted in a significant change in the way services are provided. These engagement teams usually consist of a partner, or an engagement manager, leading a project onsite, with members of the engagement team contributing to the project at offshore or near shore locations. The success of virtual or offshore teams in the IT services industry in the late 1990s led to the development of offshore and near shore teams for the major law and accounting firms. Firms leveraging low-cost resources in India, China, and Eastern Europe include large organizations, such as IBM Global Services, Wipro, Infosys, and Accenture. Many mid-market firms are adding these low-cost capabilities as well.

Disperse or virtual engagement teams are cost effective, and they allow professionals to work remotely. This is a key means of attracting and retaining talent in geographies where the PSO may not have a presence. However, as engagement teams have become more virtual, multiple time zones, language barriers, and new means of control and management have increased the challenges of managing them.

Employing contractors has increased significantly in the past few years in the professional services industry. In a recent study by Kennedy Information Advisors, the percentage of costs that contractors accounted for at management consulting firms rose from 4.3 percent of total costs in 2005 to 6.4 percent of total costs in 2007. Some of these firms employed as many as 2,000 different contractors during the course of the year. While there are benefits to hiring contractors—they can quickly bring added expertise to the engagement, require little or no training, and command no benefits from the PSO—they can often create problems for the firm. Because of the increased number of different specialists and contractors involved, PSOs have to deal with higher project complexity of the engagement, and this complicates control and management. Maintaining the schedules, skill sets, and availability of the contractors poses equal challenges.

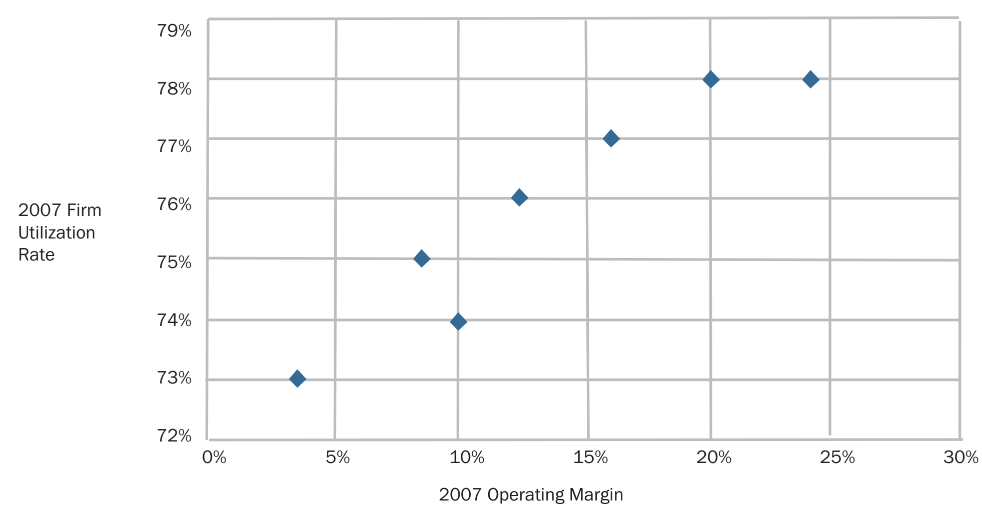
Aligning skills and people with client engagements is a long-standing issue for PSOs. Traditionally, assigning people to projects has been the task of an administrator or a process set by a legacy system. However, both alternatives can lack the scalability needed today, and they often are inefficient when it comes to determining the skill sets of the people within the organization.

Benchmarks and Operational Metrics

Benchmarks and operational metrics are key to a firm's performance. In fact, there is often a direct link between increasing margins and exceeding industry benchmarks. Some of the most common benchmarks used for project management are:

- Utilization ratio.
- Cost per professional.
- Average project size.
- On-time and on-budget rates.
- Extension rates (client renewal rate, percentage of revenues from new clients).

The utilization ratio for PSOs globally is 77 percent, according to Kennedy Information Advisors; however, this percentage may vary within verticals. For example, the utilization rate for IT services is 81 percent, while strategy consulting and legal services are closer to 75 percent. However, within these verticals, firms with higher utilization rates almost always have higher profit margins than firms with lower utilization. Industry leaders in professional services, who have a higher utilization rate than their peers, are typically more profitable and cost efficient. For example, the following table plots seven operations management consulting firms with the same business model and services portfolios. The firms with the higher utilization ratios are almost always more profitable than their peers with lower utilization ratios.



Source: Kennedy Information Advisors

Cost per professional is an indicator of both productivity and profit. In the Kennedy Information Advisors 2008 global study of consulting, accounting, and IT services firms, PSOs had an average cost per employee of U.S.$239,000 per year. However, this figure can vary significantly based on a firm's size, geographic market, and industry.

Average project size can also vary within each vertical of the PSO market. A firm's geographic location and client mix can also impact the size of engagements. However, accounting, engineering, and IT services tend to perform larger engagements than consulting firms or law firms. The following table lists the average project size of a PSO with 10 to 25 employees (from the Kennedy Information Advisors PSO study in 2008).

PSOs with 10 to 25 Professionals	
PSO Type	Average Project Size
Legal	$189,000
Accounting	$252,000
IT Services	$269,000
Management Consulting	$221,000

In U.S. Dollars
Source: Kennedy Information Advisors

On-time and on-budget rates are often difficult for firms to measure accurately because some issues, such as scope creep and rates, will vary across verticals. According to data collected in the *Consulting* Magazine survey, *Best Firms to Work For 2008*, professionals for IT services and management consulting indicated that approximately 80 percent of projects deliver on time and 85 percent deliver on budget.

Extension rates will vary by industry segment and core business, but they are usually determined by targeting 60-percent existing clients over 40-percent new clients. The percentage of new business includes revenue generated by new clients, as opposed to new product offerings or resales, such as cross-sell and up-sell within existing clients.

How Business Applications Can Improve Firm Benchmarks and Streamline Project and Resource Management

Business management applications not only allow firms to track operational metrics, but they also allow firm leaders and engagement managers access to this information in real time. One country leader of a large accounting and consulting firm stated, "One of the reasons we are so ahead of our competitors in this market is because we manage our operations very closely. I know one of my main competitors is doing a two-month study on their internal operational metrics. I receive the same data every Monday morning in a weekly report. It provides me all of our practice's metrics. So, for example, if our utilization rate is too high, I know it's time to go out and hire some new folks."

PSOs show significant evidence that, by using business management software, they can streamline the project-management function, and track operational metrics quickly and efficiently. In the 2008 global study by Kennedy Information Advisors, 30 PSOs currently leveraging PSA applications were identified. The firms who use PSA solutions outperformed firms who do not in all the following areas:

Operation Metric	KIA Sample Set	Other Firms Surveyed
DSO*	57	73
Utilization	79%	75%
Operating Margin	20%	17%
Employee/Partner Ratio	10/1	14/1

Source: Kennedy Information Advisors

**DSO represents the number of elapsed days from billing date (invoice out the door) until settlement (as opposed to outstanding days after due date).*

Financial Management

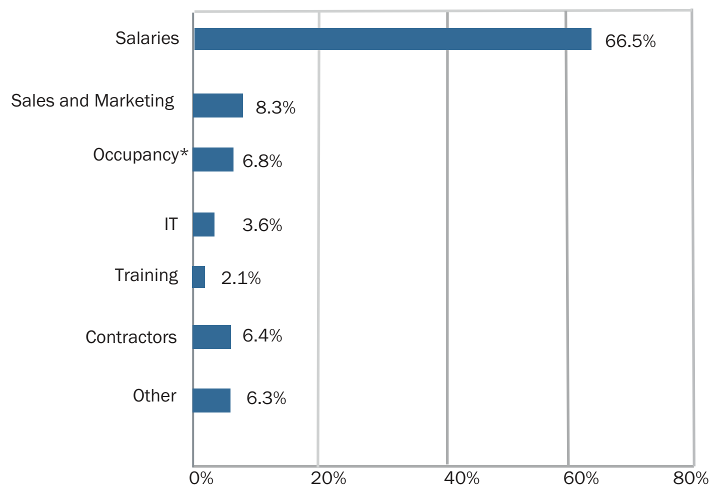
As firms face shrinking profit margins and increased pressure on billing rates, financial management is becoming more critical.

Key Challenges

With growing pressure from competition driving down price points, managing costs is a critical element for a PSO's success or failure. One element that makes managing costs so challenging for PSOs is the current war for talent. If PSOs slash salaries or support personnel, they can't attract top professionals. However, CFOs or COOs at professional services organizations can help drive down price points by controlling their firms' General, Sales, and Administrative (GS&A) costs. Diligent financial management can make a difference in controlling or reducing these costs, which include, but are not limited to:

- Sales and marketing
- Occupancy
- Contractors
- IT
- Training and development

The following graph from the *Kennedy Information Advisors 2008 Global Study of PSOs* illustrates the mean average of total costs. Costs other than salaries accounted for 33.5 percent of total costs.



Source: Kennedy Information Advisors

* *Occupancy costs are expenses related to occupying a space, including rent, real estate taxes, personal property taxes, and insurance on a building and its contents.*

Sales and marketing costs are often the largest component of many PSOs' expenses, with most averaging approximately 8 percent of total costs. PSOs often waste countless dollars on poor campaigns and marketing initiatives. This is a direct result of redundant efforts and poor understanding of the target audience.

Occupancy costs are expenses that are related to occupying a space, including rent, real estate taxes, personal property taxes, and insurance on a building and its contents. One of the benefits of implementing the virtual business model is that it can save as much as U.S.$2,500 per employee annually. However, the obvious drawback to this strategy is that it often strips the PSO of its culture and creates communication challenges to engagements' teams. Still, these pitfalls can often be offset by implementing strong collaboration tools.

Contractor costs have increased significantly over the last three years. The trend to leverage contractors within the PSO industry is being driven by: 1) The need for experienced professionals on engagements, and 2) the effort to reduce healthcare and other benefits costs associated with full-time employees.

IT costs, which averaged 3.6 percent of total costs, have increased almost 1 percent of total costs over the past three years, according to Kennedy Information Advisors. Firms are increasing their investments in resources such as CRM, mobility, and information management.

Training and development costs for staff can be reduced by using e-learning software instead of onsite seminars and classes. In the *Consulting* Magazine survey, *Best Firms to Work For 2008,* 25 percent of ongoing training was provided through Web-based tools.

Geographic and Industry-Specific Challenges

PSOs across most verticals and geographies are relatively consistent. Firms located in less-developed regions often face delivery challenges, such as having too few employees on the ground. The following table illustrates the costs of the publicly traded PSOs across the Americas, Europe, the Middle East, and Asia (EMEA), and Asia-Pacific (APAC).

Cost	Americas	EMEA	APAC
Salaries	67.6%	68.5%	61.9%
Sales and Marketing	7.5%	8.5%	11.0%
Occupancy*	6.2%	6.8%	8.5%
IT	3.8%	3.3%	2.9%
Training	2.3%	1.5%	2.8%
Contractors	6.1%	5.6%	8.2%
Other	6.5%	5.8%	4.7%

Source: Kennedy Information Advisors

** Occupancy costs are expenses related to occupying a space, including rent, real estate taxes, personal property taxes, and insurance on a building and its contents.*

However, the primary verticals (legal, consulting, IT services, and accounting) varied, with accounting and legal firms' spending more on occupancy, while consulting and IT firms invested in sales and training.

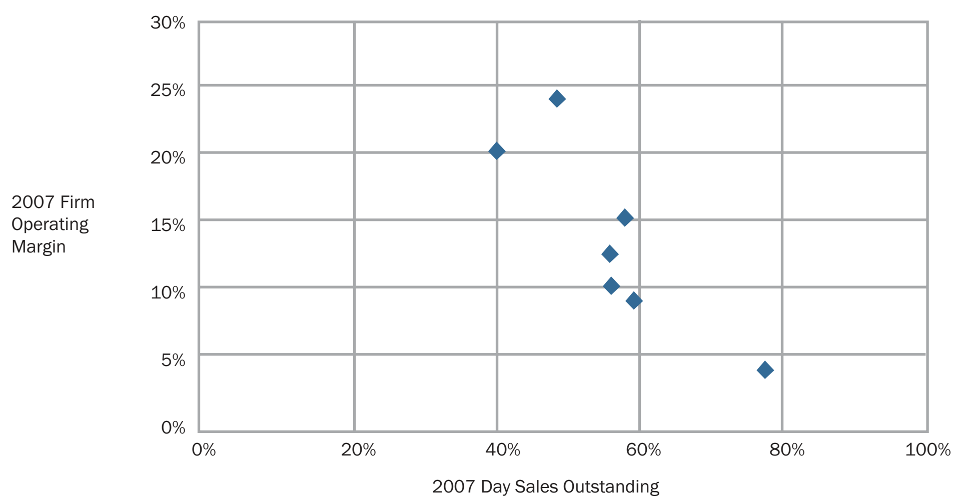
Cost	Legal	Accounting	Consulting	IT Services
Salaries	70.0%	67.2%	67.8%	65.70%
Sales and Marketing	6.0%	7.5%	8.9%	9.30%
Occupancy*	7.5%	7.2%	5.4%	6.10%
IT	2.9%	3.2%	3.2%	4.10%
Training	1.4%	1.1%	2.4%	2.20%
Contractors	6.0%	6.6%	6.9%	6.50%
Other	6.2%	7.2%	5.4%	6.10%

Source: Kennedy Information Advisors

** Occupancy costs are expenses related to occupying a space, including rent, real estate taxes, personal property taxes, and insurance on a building and its contents.*

Traditional benchmarks and metrics play a key role in measuring and streamlining businesses' DSO, which is one of the best ways to measure efficiency. While not a metric that measures profitability outright, for most companies, it can be directly linked.

For example, the following graph plots seven operations management consulting firms and illustrates the impact of maintaining a low DSO. The firms (all of which offer the same service portfolio) with a lower DSO almost always have a higher profit margin. Business management solutions play a key role in this because they can automate general ledger, payables, and receivables, and they provide CFOs and COOs better visibility into their businesses.



Source: Kennedy Information Advisors

Benchmarks, such as cost per employee and operating margin, are also strong indicators of performance; however, these benchmarks can vary considerably among PSO verticals. For example, cost per employee tends to be lower at law firms and at management consulting firms than it is at accounting or IT services firms. Operating margins also tend to vary considerably within each vertical. Law firms are likely to have operating margins close to 40 percent, while IT services margins hover at 18 percent.

How Business Applications Can Improve Firm Benchmarks and Streamline Financial Management

One of the main benefits of business management solutions is that they provide a 360-degree view into a firm's project accounting, allowing the engagement manager and the CFO to control costs, monitor variations in estimates, speed billing cycles, and reduce risk. In the Kennedy Information Advisors study, the PSOs currently leveraging PSA software exceeded their peers' performance. The firms maintained lower occupancy, training, and other costs, which enabled them to invest more in sales and staff.

Cost	Firms Using a PSA System	Firms Not Using a PSA System
Salaries	67.6%	66.3%
Sales and Marketing	8.6%	8.1%
Occupancy*	6.3%	6.8%
IT	3.2%	3.6%
Training	2.6%	2.1%
Contractors	6.3%	6.8%
Other	5.4%	6.3%

Source: Kennedy Information Advisors

** Occupancy costs are expenses related to occupying a space, including rent, real estate taxes, personal property taxes, and insurance on a building and its contents.*

Today's business management solutions can streamline financial management processes by integrating data from disparate systems, and they can control general ledger, payables, receivables, inventory purchasing, fixed assets, and cash flow, all of which provide a firm's decision makers with a better picture of their business—in real time.

Financial Reporting

Government regulations and demanding clients who require complex project reporting and financial accounting are driving PSOs to leverage tools that can enhance their financial reporting capabilities.

Key Challenges

As has been previously stated, PSOs face an ever-increasing need to generate more information through portals or by customized management reports in real time. PSOs need key performance indicators (KPIs) that measure performance and that alert management of conditions that need to be investigated. These KPIs can be based on some of the benchmarks in this report, or they can use the goals established per firm. KPIs improve project efficiency and manage internal costs. This is especially important when dealing with the increasingly complex reports that the more demanding clients insist on and that threaten to drive up costs. Not only do these clients want more detailed financial project reports, but they also want to set more project milestones. In addition, increasingly stringent government regulations require greater reporting capacity and processes that are specific to the geography in which the firm operates.

Firms need business management solutions that can help them:

- Gain better insight into the actual costs.
- Leverage data more quickly to comply with mandated client requirements.
- Comply with new government regulations.

Gain better insight into the actual costs. In this fast-paced global economy, firms need more customized reports in real time to help them analyze business operations in new ways and gain new intelligence about internal operations. Decision makers will need to analyze projects in greater depth to identify profitability and cost by client, project type, and project teams. One of the dangers firms face is that of projecting project costs incorrectly. This can be highly detrimental to any PSO, especially when bidding on a large, long-term project.

Leverage data more quickly to comply with mandated client requirements. During the past five years, as clients have become more sophisticated buyers of professional services, the demands they place on PSOs have increased significantly. PSOs need to access data more quickly to show return on investment (ROI) on their proposals and meet these increased demands.

Comply with new government regulations. Firms need to devote resources to comply with increasing and ever-changing corporate regulations for the regions in which they do business. For many mid-sized and smaller PSOs, this will create new challenges in the way that partners manage their time. Already, most directors at mid-sized firms spend too much of their time running the business and not enough time with their clients. In the *Best Firms to Work For 2008* survey by *Consulting* Magazine, consultants at small and medium-sized firms spent only 70 percent of their time on client engagements and business development, and they spent 30 percent on financial and back-office functions. On the other hand, their counterparts at larger firms were able to spend 80 percent of their time on client engagements and business development.

Geographic and Industry-Specific Challenges

PSOs will require better financial reporting capabilities globally, but the roles that financial reporting will play in developed markets versus new markets will be very different. As competition increases, many firms will look to new markets in less developed regions to supplement and develop business. As firms expand into these new markets, such as Latin America and Southeast Asia, they will need to manage the risks.

How Business Applications Can Improve Firm Benchmarks and Streamline Financial Reporting

While financial reporting business applications provide PSOs with real-time financial intelligence about their business operations, help manage risk, and streamline their operations, their key function is to provide more time, which allows senior managers and partners to focus on clients. While senior leadership will always spend a certain amount of their time running the business, as one partner at a financial consulting firm stated, “Every moment I’m not billing a client, I’m losing money.”

Business management applications allow firms to better manage budgets, create and consolidate reports, and look for trends and relationships in all parts of the business. Firms also gain more visibility into financial and project accounting, and this allows them to maintain tighter control over costs, shorten billing cycles, monitor variations in estimates, and help track trends in profitability.

Conclusions

The key to running a successful professional services organization is optimizing the time of its billable staff. Implementing business management applications not only allows firms to increase billable hours, but it also allows them to reduce costs, identify business opportunities faster, and maintain relationships with clients. In the end, business management solutions enable PSOs to better understand their businesses and their processes. As is often the case, the doctor typically cures himself last. The same is true of PSO decision makers, who advise their clients very effectively about how to improve their businesses, but often ignore or simply forget to optimize their own business development and delivery processes. It is amazing how many PSOs manage their businesses with a series of spreadsheets, yet they would never recommend that any of their clients do the same—not even as a tactical solution.

PSA solutions, no matter how sophisticated they are, instill a significant amount of discipline into the firm management of “firmware”; even the least complex tools help to increase a PSO’s understanding of its internal and external processes. A large number of mid-sized embedded consulting firms (PSOs that are extensions or spin-outs from large corporations, such as Shell Solutions or DuPont Safety Resources) quite successfully take advantage of large enterprise resource planning (ERP) implementations at their parent corporations. However, they are often impacted by the complexity of these installations. Still, the advantages of PSA solutions always outweigh the disadvantages. Free-standing small to mid-sized PSOs should learn from the information presented in this white paper and from their own advice to clients and should implement appropriately sized and custom-tailored PSA solutions. This will not only help them to survive in increasingly more competitive and trying times, but it will also allow them to differentiate themselves from the competition. What better reference can a consulting company produce than to say to a prospect, “This is how we improved our own effectiveness and efficiency—let us help you do the same!”?

Surprisingly, consulting companies are the least likely to implement PSAs. Because of the nature of their business, it would seem that an awareness of the need for this functionality would come naturally to them, but their constant client focus seems to distract them from their own business model. Law, tax, and accounting firms are often most acquainted with running PSA or PSA-like solutions, probably because of their habit of billing clients by the hour. IT PSOs, in general, fall between consulting and accounting PSOs, by often running systems developed in-house, while typically promoting to their clients best-of-breed approaches.

No matter which horizontal you are in, and no matter how large or small your professional services business is, it's a good idea to apply the same rigor to resource management as do most verticals that want to be top quartile performers.

Economic conditions are constantly in flux, especially in a worldwide economy. We have witnessed that, in prosperous times, many PSOs are too busy to implement solutions, yet when business is slower, budget constraints impede implementing the needed solution. Still, we have also witnessed that tough economic periods are a perfect time to prepare for a rebound, which will certainly see new winners and losers. Firms that do not focus on optimizing project and financial management capabilities could find themselves out of business, as many consulting firms did after the dot-com bubble burst in 2000 and the markets revived.

About Microsoft Dynamics

Microsoft Dynamics is a line of integrated, adaptable business management solutions that enables you and your people to make business decisions with greater confidence. Microsoft Dynamics works like familiar Microsoft software, such as Microsoft Office, which means less of a learning curve for your people, so they can get up and running quickly and focus on what's most important. Built to work with Microsoft technologies, it works easily with the systems your company already has implemented. By automating and streamlining financial, customer relationship, and supply chain processes, Microsoft Dynamics brings together people, processes, and technologies, helping increase the productivity and effectiveness of your business and helping you drive business success.

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