Five Key Performance Indicators for Greater Financial Success

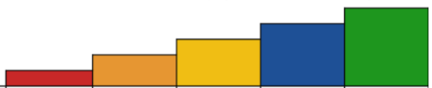
Service Performance Insight, LLC

Introduction

Service Performance Insight (SPI Research) believes the professional services market is back – showing growth rates in excess of 10%. This growth bodes well for PS executives who work to expand geographically and introduce new services. However, it is not all clear sailing in the market. There are a number of key issues facing PSOs that could limit growth and profitability in the upcoming decade.

One of the most important issues facing PS executives is profitable growth. As PSOs expand geographically, the complexities associated with bill rates; different regulatory environments, worker compensation and workload continue to burden both cash flow and profitability.

Figure 1: Focus on Financial Maturity Improvement



	Level 1 Initiated	Level 2 Piloted	Level 3 Deployed	Level 4 Institution.	Level 5 Optimized
Annual revenue per billable consultant (k)	$159	$188	$223	$251	$252
Annual revenue per employee (k)	$115	$156	$180	$211	$215
Billable Utilization	64.1%	67.9%	71.7%	78.7%	80.0%
Project Margin	26.4%	35.6%	37.3%	40.0%	47.3%
Project overrun	9.9%	9.4%	9.1%	8.3%	7.1%
Earnings before Income Taxes, Depreciation & Amortization (EBITDA)	**1.3%**	**9.8%**	**13.2%**	**27.1%**	**37.0%**

Source: SPI Research, December 2013

Does PS Financial Maturity Matter?

SPI Research has spent the past seven years benchmarking PSO operational performance or "maturity" to determine the characteristics and appropriate behaviors for PSOs based on their organizational lifecycle stage.

Figure 1 depicts *financial* maturity level progression and outlines primary characteristics for each maturity level. The bottom line is that as organizations improve performance through better focus, alignment, communication and collaboration, the more "mature" they become. The figure depicts a subset of the 200 Key Performance Indicators (KPIs) tracked within the benchmark but clearly demonstrates overall performance improves as organizations mature by aligning their people, processes and systems.

The most mature organizations exhibit high levels of organizational visibility with optimized business processes and integrated systems, which span all major functional groups. The figure shows the dramatic improvement in key metrics as PSOs optimize or "mature" their people, processes and systems. While individual metrics show strong improvement, overall net profitability (EBITDA) is the greatest beneficiary of increased visibility and alignment.

Focus on Profit Improvement

Professional services organizations must continue to focus on delivering high-value and high-margin services in order to meet profit objectives. This goal will not be easy as PSOs face:

- ∆ A shortage of talent due to baby-boomer retirement and fewer STEM (science, technology, engineering and math) graduates from local universities;
- ∆ Increased clients demands and expectations for greater service value for their dollars;
- ∆ More complicated projects, which require resources remotely scattered; and,
- ∆ Different billing structures which complicate invoicing and managing cash flow.

There are hundreds of metrics where professional services organizations can improve financial performance. In the following sections, SPI Research will highlight five of the most important financial metrics. Each of these initiatives focuses on improving certain aspects of their business.

Annual Revenue per Billable Consultant

Annual revenue per billable consultant depicts the service organization's total revenue divided by the number of billable consultants. Revenue per consultant provides an indication of consultant productivity. SPI Research considers revenue per billable consultant to be one of the most important KPIs, but it must be viewed in conjunction with labor cost.

Revenue per billable consultant should minimally equal one- to two-times the fully loaded cost of the consultant. Revenue multipliers of three and higher are typical for engineering and architecture firms, as well as in management consulting and legal professional services.

Table 1 highlights the importance of optimizing real rates and hours worked, which ultimately drives revenue per billable employee. SPI Research considers $200k in annual revenue per billable consultant as a good start. Organizations with high annual revenue per billable employee tend to do well because they complete larger projects, have much more revenue in backlog, complete work on-time and on-budget minimal waste, and have higher billable utilization for their consultants.

Table 1: Maximize Annual Revenue per Billable Consultant

KPI	Over $200k	Under $200k	▲
Annual revenue per employee (k)	$214	$116	84%
Average revenue per project (k)	$208	$193	60%
Quarterly rev. target in backlog	48.3%	36.7%	32%
% of billable work is written off	2.8%	3.7%	25%
Billable utilization (2,000 hours)	74.2%	68.5%	8%
EBITDA %	**18.6%**	**13.3%**	**40%**

Source: SPI Research, December 2013

Annual Revenue per Employee

Annual revenue per employee is different from revenue per billable employee, it focuses on organizational effectiveness. It is similar to annual revenue per billable consultant; it divides total revenue by the total number of employees so it includes both billable and non-billable employees. Revenue per employee is a powerful indicator of the overall profitability of the firm because if the average cost per employee is known, profit can be estimated representing the difference in cost per employee and overall revenue per employee. Similar to revenue per consultant, this KPI is highly correlated with profitability, utilization and bill rates.

PSOs with a high percentage of non-billable employees have lower annual revenue per employee. Revenue per employee is very important in determining the appropriate size and financial health of the organization. Based on the high cost of talented consulting staff, SPI Research believes this figure should be close to two times the fully loaded cost per person to maintain strong financial viability. If the organization achieves an acceptable revenue yield per billable consultant but is below the benchmark for overall revenue per employee, it is an indication of too much non-billable overhead or lavish discretionary spending. Table 2 shows that organizations with high levels of annual revenue per employee also complete larger projects efficiently.

Table 2: Maximize Annual Revenue per Employee

KPI	Over $180k	Under $180k	▲
Average revenue per project (k)	$209	$155	34%
Average project overrun	7.2%	10.4%	30%
Revenue leakage	3.3%	4.6%	28%
Quarterly rev. target in backlog	47.4%	40.6%	17%
% of annual margin target achieved	92.3%	85.0%	9%
EBITDA %	**20.2%**	**14.0%**	**44%**

Source: SPI Research, December 2013

SPI Research considers over $180k per employee as the minimum for financial success. Because this metric differs from annual revenue per billable consultant due to the additional overhead resources, it is critical PSOs minimize non-profit generating areas. While virtually every professional services organization with over 20 employees has some contingent of overhead, ideally it should be to less than 30% of the workforce.

Billable Utilization

SPI Research defines employee utilization on a 2,000 hour per year basis, and is calculated by dividing the total billable hours by 2,000. This key performance indicator is central to organizational profitability. Utilization is consistently the most measured key performance indicator but must be examined in conjunction with overall revenue and profit per person along with leading indicators like backlog and size of the sales pipeline to become truly meaningful. Utilization is a major indicator of opportunity and workload balance as well as a signal to expand or contract the workforce.

Table 3: Maximize Billable Utilization

KPI	Util. over 70%	Util. under 70%	▲
% of billable work is written off	2.3%	4.3%	48%
Average project overrun	6.9%	11.4%	39%
% of "referenceable" clients	82.9%	65.3%	27%
Projects canceled	3.3%	4.3%	23%
Projects delivered on-time	83.2%	74.1%	12%
Annual revenue per employee (k)	$175	$164	7%

Source: SPI Research, December 2013

Table 4 compares the impact of employee billable utilization of more than 70% (1,400 hours annually) with those less than 70%. As one might expect, billable utilization is critical in terms of meeting deadlines, revenue and client satisfaction.

Although PS firms would like to abandon the billable utilization metric (and all the accompanying time tracking it entails), unfortunately there is no other metric which provides as good a picture of workforce productivity. Perhaps as more and more firms shift to fixed price work the focus on billable utilization will decline but if this is the case firms will have to ratchet up their focus on project accounting and budget to actual performance. But here again, how can budget to actual performance be measured without tracking work hours?

Project Overrun

Project overrun is the percentage above budgeted cost to actual cost. Project overruns may be expressed in actual time versus plan or actual cost versus plan or both. This KPI is important because anytime a project goes over budget in either time or cost; it cuts directly into the PSO's profitability.

Project overruns, like projects not delivered on time, limits future work that can be initiated. In many instances it shows a lack of project governance, which negatively impacts bottom-line results.

Table 4 compares the average project overrun of under 5% to those with overruns of over 5%. As one might expect the greater the project overrun the fewer projects are completed on time. While this KPI is obvious, the table highlights just how detrimental project overruns are to the organization. This table shows that not only are projects canceled as overruns occur. While this KPI is obvious, the table high-lights just how detrimental project overruns are to the organization. This table shows that not only are projects canceled as overruns occur, but also that client satisfaction, and ultimately new sales decreases as overruns occur.

Table 4: Minimize Project Overrun

KPI	Overrun under 5%	Overrun over 5%	▲
Projects canceled	2.1%	4.9%	57%
% of billable work is written off	2.1%	3.8%	46%
% of "referenceable" clients	80.1%	71.7%	12%
Bid-to-win ratio (per 10 bids)	5.43	4.95	10%
EBITDA %	**14.2%**	**17.2%**	**17%**

Source: SPI Research, December 2013

Project Margin

Project margin is the percentage of revenue which remains after paying for the direct costs of delivering a project. Projects can be fixed-price or milestone-based, where the PSO commits to a "Not to exceed" price, or Time & Expense, where the PSO essentially charges by the hour with additional payment for any materials used during the engagement.

Table 5 highlights the importance of project margin. PSO financial performance suffers greatly when project margins drop below 40% on average. Because project margin is the profit that ultimately drive PSO overall profits. Low margins do not allow PSOs to invest in future growth.

Table 5: Maximize Project Margin

KPI	Over 40%	Under 40%	▲
Annual revenue per consultant (k)	$227	$193	17%
% of billable work is written off	2.8%	3.3%	14%
Annual revenue per employee (k)	$182	$164	11%
% of "referenceable" clients	78.2%	73.6%	6%
Revenue leakage	3.9%	4.2%	6%
Bid-to-win ratio (per 10 bids)	5.42	5.12	6%

Source: SPI Research, December 2013

Manage Finances

The key to any successful professional services organization meeting their financial objectives is the management of all revenue and cost information. The core financial management solution is the hub of all of this information. It must provide an infrastructure where costs and revenues can easily be analyzed and where key members of the executive team can drill down to better understand areas of success in areas of improvement.

A professional services organization's financial infrastructure can be complex, with different rules and regulations and currencies that must be managed in order to reduce waste and fraud, while maximizing profitability. The solution must also be flexible and agile, so that as conditions change, such as mergers and acquisitions, practice changes, new regions, and other areas, that the financial information will remain transparent, stable and accurate.

Conclusions & Recommendations

Service Performance Insight expects 2014 to be another banner year in the professional services market. While there will always be issues that could impede an organization's ability to meet and exceed profitability objectives, none are so insurmountable that PSOs focused on financial performance, success cannot achieve their goals.

There are literally hundreds of financial KPI's, used by chief financial officers to better dissect and understand their business. In this white paper SPI Research went through five that are analyzed annually in the Service Performance Insight Professional Services Maturity™ Benchmark.

Ideally, the core financial management solution is integrated with the other departmental solutions so that information, such as sales and client, employee costs, service delivery costs and revenues, and other relevant information can be seamlessly passed to it. With this information at the fingertips of the executive team, confident decisions can be made to help grow the professional services organization.

Service Performance Insight (SPI Research) is a global research, consulting and training organization dedicated to helping professional service organizations (PSOs) make quantum improvements in productivity and profit. In 2007, SPI developed the PS Maturity Model™ as a strategic planning and management framework. It is now the industry-leading performance improvement tool used by over 6,000 service and project-oriented organizations to chart their course to service excellence.

SPI provides a unique depth of operating experience combined with unsurpassed analytic capability. We not only diagnose areas for improvement but also provide the business value of change. We then work collaboratively with our clients to create new management processes to transform and ignite performance. Visit www.SPIresearch.com for more information on Service Performance Insight, LLC.

© 2013 Service Performance Insight

Service Performance Insight (SPI Research) is a global research, consulting and training organization dedicated to helping professional service organizations (PSOs) make quantum improvements in productivity and profit. In 2007, SPI developed the PS Maturity Model™ as a strategic planning and management framework. It is now the industry-leading performance improvement tool used by over 6,000 service and project-oriented organizations to chart their course to service excellence.

SPI provides a unique depth of operating experience combined with unsurpassed analytic capability. We not only diagnose areas for improvement but also provide the business value of change. We then work collaboratively with our clients to create new management processes to transform and ignite performance. Visit **www.SPIresearch.com** for more information on Service Performance Insight, LLC.

© 2013 Service Performance Insight