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Driving Out Failure Costs

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All firms have the ability to control better their underlying cost structure. Effective cost control covers two distinct realms: opportunity cost and failure cost. Opportunity cost results from what doesn't happen (not pursuing new markets or projects, for example), and failure cost results from tolerating suboptimal performance within the organization. Both are expensive but in distinctly different ways.

While opportunity cost retards growth, it does not directly burden the bottom line. Failure cost, on the other hand, is a huge anchor that drags down the entire firm. Consider this simple example: Losing \$100,000 on a project not only affects the current year's profitability, it also means that the firm must secure a new \$20 million project with a 5 percent fee and then make a 10 percent profit just to get back to break even. All that extra effort (with the attendant liability) doesn't put one extra dime on the bottom line. Viewed in this light, the true effect of failure cost is insidious — it can last for years.

When creating and reviewing the firm's annual budget, each line item should be scrutinized with these questions in mind: How is this cost supporting the design mission of the firm? Can we achieve the same effect in some other way? What actual difference would it make if we reduced or eliminated this item from the budget altogether? Is there another more effective way to spend the same money? All firms have finite resources, and the point of asking such questions is to make sure you are making the best possible use of the money that is actually available to run the organization. Tolerating failure cost is like placing an unnecessary tax on your future success. Call it "voluntary misfortune."

Even small costs can make a big difference. Consider the annual ritual of sending out holiday cards. Including the time spent deliberating and designing the card itself, plus the cost of production, mailing, and administrative time to get it all done, firms can easily spend upwards of \$5,000 to \$10,000, and often much more. That same amount of money would buy 50 or 100 client lunches at \$100 each, which is probably a much more effective use of marketing dollars. On the other hand, the occasional extravagance can pay big dividends, as long as it is strategic and carefully targeted. Spending money on a lavish holiday party for the staff and clients can have a palpable effect on both morale and productivity.

It's important to establish a clear link between cost control and your firm's value system. Invest in what you believe in, and invest in visible ways so that the staff understands what you are trying to accomplish with the money available. Each decision — whether spending money or cutting a line item from the budget — sends a very loud message. And remember: Budgets are a tool, not a weapon. They should be viewed as enabling rather than restricting. Their ultimate value is in helping the firm make strategic decisions. Here are a few specific tips for how to drive out failure costs in your organization:

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- On an annual basis, track the revenues and profits produced by each principal in the firm. You'll know at a glance who your most productive leaders are.
- Ditto for project managers. Which ones consistently make money on projects and which don't? The sub-par performers should be given additional training or be reassigned.
- Mistakes in documentation are hugely expensive, so conduct an objective quality audit. Determine the cause of your most frequent sources of errors and omissions claims and then institute specific quality control standards and procedures to make sure that they don't reoccur.
- Review your marketing budget to understand your actual cost-of-sales (the amount of money spent, in both labor and materials, to secure each dollar of new fee). Make sure that all marketing activity is targeted to achieve specific results. Track who spends what and how much new work results from the effort.
- Scrutinize your supply chain. Work with vendors who will agree to provide stock (paper, pens, etc.) on an as-needed basis. Consider outsourcing all printing. Make sure that all reproduction costs and reimbursable expenses are separately billed. Generally, these run between 5 percent and 7 percent of the contract value — a large percentage of your profit margin.
- Avoid pass-through fees for engineers and consultants. Your firm runs significant liability for their work and also has the burden of billing and collections. You cannot afford to provide this service for free. If clients demur, have the consultants bill them directly. This will lower your insurance cost and reduce administrative overhead.
- Conduct a technology audit. Make sure that your staff have all the hardware and software they need, but don't gild the lily. Even more important, provide the training to ensure that the technology available is actually being used to its fullest capacity.
- Review travel and entertainment expenses on a regular basis. In general, any events involving direct client contact are of high value and should be supported. Participation in professional organizations can also pay big dividends (as long as clients are also regular attendees). Don't be afraid to spend money on travel and entertainment, just make sure you're spending it in the right places.
- Invest in high-quality teleconferencing equipment and file-sharing software and insist that your clients and consultants do the same. This will enable you to have productive coordination sessions without leaving the office. Multiply the hours saved by your average billable rate and it's easy to see that the equipment will pay for itself in no time.
- Review your telephone and Internet provider contracts every 12 months. There are frequently savings to be had. Also review your cell phone policy. It may make sense to keep several active cell phones at the front desk that can be checked out on an as-needed basis rather than providing individual phones to staff.
- Review your lease. Moving to less expensive or smaller space will save money each and every month. Also consider sub-leasing a portion of your space if it is truly under-utilized.

- Review your staff benefits package and benchmark it against peer firms. Pay particular attention to vacation policy (place appropriate limits on carry-over), the use of sick time (don't let it be used as supplemental vacation time), and the cost of health insurance (it goes up every year, which may require adjusting coverage). However, don't stint on benefits — it pays to be competitive when recruiting new talent.
- When times get slow, consider loaning out or furloughing staff to other offices, bringing them back when work picks up. This is much cheaper than recruiting new hires. When times get busy, use this technique in reverse: You can get a temporary boost in staffing capacity without the burden of long-term costs.
- Benchmark your fee structure against peer firms. Are you actually charging enough? You might be surprised to learn that the market will support an upward adjustment, especially if you can tie the increases to metrics such as on-time/on-budget performance. Make sure that you charge for all legitimate additional services as the project scope and schedule changes. Additional services frequently run in the range of 5 percent to 10 percent of the face value of the original contract.
- Perhaps most important, carefully review your staffing profile. Salaries are, by far, your biggest cost, at roughly 50 percent of operating revenue. Who are the star performers? Pay them above market to provide proper incentive and set an example for others. On the other hand, cut those who are chronic complainers or habitually non-productive. This will not only improve performance, it will raise morale across the board since people will know that you are serious about quality and productivity.

Finally, ask yourself this question: If you were newly arrived in town and looking for the ideal place to work, would you choose your own firm as the place to go? If not, why not? An honest answer to this question will tell you all you need to know about driving out failure costs.

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