White Paper 2012-05

How to Be On Top of Your Costs: the Art of Mastering Commitments

Nothing is worse on a project than not to have an accurate, up-to-date view of the current costs. The key to rigorous cost control of current costs on a project lies into the management of commitments. This paper looks into the reasons, what it entails, and how to successfully record and manage commitments.
*As a sequel, a second White Paper (2012-06 "*No Surprises: the Recipe for Consistent Project Controls*"), addresses the issue of accurate forecasting of future cost.*

Why is the control of commitments so crucial in large projects?

In projects, many activities are done which are not repeated; they are often unique. In addition, the volume of activities performed at one particular point in time is often extremely variable, sometimes ranging from 1 to 10 in terms of instantaneous expenditure (think of the contrast between engineering and construction phases). Moreover, in large construction projects, activities are being performed simultaneously in different locations, some quite remote, and often involve unforeseen activities.

The observation of received invoices from suppliers and subcontractors – the traditional accounting way - will only give a view of what has happened a few weeks ago; or even a few months ago if activities are being performed in remote corners of the world. A project that would rely only on the received invoices is thus exposed to an inaccurate representation of the costs it has actually spent at the present moment. There are stories of projects which have taken unforeseen downgrades of dozens of millions of dollars for activities in remote locations which had not been accounted for – until the invoices hit the project office months later.

Why is the control of commitments not a standard financial practice?

The conventional financial systems of the Industrial Age have been developed around the assumptions of manufacturing: that activities are generally similar and repeated, and that the volume of activities does not change too quickly over time. In that situation, the observation of the past (invoices received) is a good enough predictor of the present and future.

As we have seen, the nature of project work is fundamentally different from manufacturing work. Relying on the past invoices is not sufficient. It thus requires a different practice to be able to have an accurate view of the current expenditure: the control of commitments.

What is the control of commitments?

The control of commitments is a simple concept. It involves the control and registration of all the cost commitments of the project before the cost is effectively incurred.

Many words in this sentence are important for the effective implementation of commitments control.

- Commitments need to be controlled: before they are signed, they are checked against the budget (the expected cost of that activity);
- Commitments need to be registered: there needs to be commitment databases that can serve as a basis for actual cost estimates;
- Commitments need to be signed off before the cost has been effectively incurred: this is a key issue in practical implementation that is crucial to the effectiveness of the commitment control system.

Because commitments are signed off and registered before the activity takes place, it is a natural consequence that the final cost of the activity might be slightly different from the original commitment due to operational reasons. This is often a stumbling block for accounting-trained cost controllers. Yet it is not necessarily a problem. Commitments do not replace invoices and standard accounting practice. It is an other, different, layer of control. What is important is that the order of magnitude of the commitments is known; and often, inaccuracies at the commitment stage tend to cancel out in the overall sum.

How to effectively control commitments?

Once the need to control commitments at their source has been clearly established, a commitment control process needs to be put in place. The stability of this process will rely on 3 legs:

- A commitment identification and sign-off process and system
- The enforcement of discipline in raising commitments
- A commitment reconciliation process

We examine successively all three legs.

The commitment identification sign off process and system

There need to be a process for raising commitments that responds to the following requirements:

- Be accessible from all work sites to raise commitments, and be simple and quick;

- Allow the authorized signatory to sign-off before the actual event even if he/she is not on the same site (often, in the project office);
- Link the commitment to an existing contract / framework agreement;
- Link the commitment to the project breakdown structure;

Although paper commitment forms can be shuffled around for signature via email and registered manually in spreadsheets, it is much more efficient in the current age to rely on systems that are accessible from anywhere through internet, contain workflows for approval and automatically register the commitment in a database. Approved commitments are then printed out on the site.

This commitment control system can even be worked out to be an extension of the procurement software so as to give a complete view of the overall procurement situation. Several solutions are available today that are cheap and effective. Mobile solutions can even be considered using wireless data connection, making remote sites really not an excuse any more to avoid controlling commitments in real time.

The enforcement of discipline

Any commitment control system needs to be enforced.

Project leadership needs to underline how important the proper control of commitment is, and publicly intervene if the commitment control process is not used or not properly used. It is a very essential part of the implementation of such a system, which is made more difficult by the remoteness of many users. Clear expectations need to be set to the entire project team from the onset of the project. Leadership should not agree to sign off on a commitment for an activity that has already been performed, except in exceptional cases justified by an urgent operational need and the unavailability of the signatory.

One way to further ensure that the process is being adhered to is to explain to suppliers and subcontractors that they will only get paid if they can show a signed-off/ approved commitment from the project. This generally will help making sure that commitments are being produced and signed off in a timely manner, as the subcontractor will not perform the work without a clearly approved commitment!

The reconciliation process

After the activity has happened and the invoices have been received, a reconciliation with the commitments must be made. The values might be slightly different, leading to some slight offset in the overall value, but it is certainly not acceptable to pay for an activity which has not been committed.

Special cases

Commitments are not only of concern for suppliers and subcontracts. Personnel time is in effect, also a commitment. The commitment control system here is the timesheet system, which needs to be enforced and approved regularly.

The link with accounting

Through the commitments control process, the project knows at any time, what is the actual cost that has been spent. The difference with the invoices received is booked as an accrual in the accounting system. This helps to give an accurate view of the financial situation of the project and hence, of the company.

Conclusion: the control of commitments, the first key to effective project controls

The control of commitments is not a conventional accounting process. Still, it is a primordial practice for large projects so as to give a good grip on what is actually happening in terms of cost actually spent at any point in time.

The right implementation of commitment control involves setting up the right infrastructure and process; implementing the right discipline; and reconciliation with accounting at the close-out stage.

Once the present cost is known precisely, the second key to effective cost control lies in an accurate forecast of the remaining cost until project completion.

As a sequel, a second white paper (2012-06 "*No Surprises: the Recipe for Consistent Project Controls*"), gives that second key to effective cost control.

Notes

1. For a more complete discussion of the limitations of Industrial Age accounting, refer to "*The Fourth Revolution, how to thrive through the world's transformation*" by Jeremie Averous, ISBN 967-10358-0-1.