A Consultant's Guide to Profitability

Part 1: Understanding Total Project Expenditure (TPE)

Part 1 of a 3-part Series

Philip Ammerman
Managing Partner
Navigator Consulting Group

One of the greatest challenges for a consultant or consulting firm is keeping track of project profitability. There are so many factors which affect it, starting from poor financial bidding to unexpected expenses due to changing client requirements, that many companies prefer to avoid the issue of bottom-line analysis (or project profitability) in favour of tracking the top-line (or project turnover).

Yet monitoring the real state of project profitability is critical, for the following reasons:

- It helps a consultancy understand the accuracy of its financial bidding process. Most of the time, the bidding process is dominated by financial competitiveness: therefore, financial proposals are pitched as low as possible. This often leads consultants into a trap: consistently working at prices which are below optimum value for the service generated, or in some cases, below break-even.

- It helps a consultancy understand which of its clients are truly worth working for. While a lot of consultancy work is relationship management and referral business, if this work isn't priced correctly, it leads to repetitive losses, or to financial constraints on growth.

- It helps a consultancy understand which of its staff members are able to perform within the financial constraints of a project, and which analytical or service functions need to be improved to comply with financial parameters.

The following methodology has been developed based on 20 years of international consultancy experience in both the public and private sectors in Europe and further afield. It's been developed in-house by my company, Navigator Consulting Group, based on our own experience and frankly speaking, our own mistakes in the consulting business.

We all learn from error, and hopefully this experience and the methodologies which have emerged from it will help you in improving or understanding the financial dimension of your own consulting work.

The approach is applicable to individual consultants working on projects, as it is to larger consultancies deploying project teams.

Understanding Project Yield (Gross and Net Profit)

In order to arrive a project yield, or project profitability, we need to calculate all income derived from a specific client for a specific project, and from that income subtract all direct and indirect expenditure which is necessary to implement that project.

While simple in definition, this is often difficult in practise, since most consultancies do a bad job of recording project expenditure, while their project income is a result of contracting and invoicing and usually not open to debate.

We have to remember that each consultancy has fixed costs: staff, rent, utilities, telecommunications, training, bidding, etc. These costs have to be accurately modelled and a share thereof deducted from project costs (or assigned to project costs) in order to adequately cover annual operating expenses. This is much more difficult than it sounds, and will be the subject of a separate article.

I will illustrate the project yield approach using an example of a training programme my company, Navigator has contracted to deliver to one of our clients, a Chamber of Commerce & Industry.

This is a blended training / consultancy project, based on 2-days of training, followed by 1-day consultancy visits per corporate participant. The project takes in two cities, meaning that travel costs are required. This project is a good example of a fixed-budget contract, i.e. one in which the client will pay a fixed sum of money in exchange for a specific service contract.

The Project Budget

The total project income is typically expressed in terms of the number of days worked: [Training Seminar + Visits] x EUR 1,000/day.

There is an additional budget for reimbursable expenses: airfare, per diem and materials. Per diem in this case is defined as all project expenses incurred while on mission. These are typically hotel costs, food, taxi/transport, etc. Public sector clients, such as the European Commission, insist that per diem is only billable per night while on mission in the project area. Thus, if someone spends Friday working on mission, but flies home on Friday afternoon, per diem may not be applicable, because there was no night spent in the project area.

The total budget as expressed in the bid is seen below:

Table 1: Project Budget in the Financial Proposal

1. Consulting Fees	# Units	Rate/Unit	Total Fees
Training Programme	2	1,000	2,000
Company Visits	8	1,000	8,000
Total Fees	10		10,000

2. Reimbursable Expenses	# Units	Cost/Unit	Total Expenses
Airfare	1	450	450
Per Diem	12	175	2,100
Materials	10	10	100
Total			2,650

Total Project Budget	12,650
Discount 15%	1,898
Final Budget in Financial Offer	10,753

In order to further our chances of winning the project, we have included a 15% discount on the project price. Discounting is often practised by consultancies. Most of the time, however, it is a "covert" discounting: when bidding, consultancies lower the rate per day or the number of days needed to do the project, thus lowering the final price. Whether a discount is over (on the budget) or covert, it is extremely important to know what this discounting is, in order to understand where project losses are incurred.

For reasons of simplicity, I've listed this on the budget, but just remember that in your company, there may be an "invisible" discount: one that has been discussed among your staff during the financial proposal stage, but which is not shared with the client.

In other projects (particularly for European Union tenders), the client will establish a maximum budget amount, and then award points to the lowest bidder. In this case, the discount is a very visible one.

The Project Expenditure Record

Perhaps the most important calculation you will ever make on a project is not something for the client, but something for yourself: it's your project expenditure record.

You need to record all expenditure on a project over the entire project lifecycle. This expenditure is incurred:

1. During the bidding process
2. During the project implementation process (assuming the project is awarded)
3. After the project has been completed, but before final payments have been collected.

This is where most consultancy accounting systems break down. They tend to record only direct project expenditure, and ignore bidding costs and post-project expenses. Let's look at a typical project accounting example. Table 2 shows the direct project expenditure (reimbursable expenditure) for the training project Navigator did for the Chamber of Commerce and Industry.

Table 2: Project Expenditure Record: Direct Project Expenditure

Project Cost Accounting	# Units	Cost/Unit	Total Expenses
Airfare			
Flight Ticket 1	1	273	273
Flight Ticket 2	1	321	265
Total Airfare	2		538
Hotel Bill			
Hotel - Room Nights	11	120	1,320
Hotel - Internet Cost	10	15	150
Hotel - Room Service, Extras			360
Total Hotel			1,830
Taxis, Total Value	21	na	342
External Meals, Total Value	12	na	264
Total Per Diem			2,436
Materials	20	5	100
Total Project Costs			3,074

The DPE record already shows that the project went over budget. Airfare was higher that forecast: this is usually the case because when you are forming a budget, you tend to take the lowest airfare found in an airline CRS. When actually booking tickets, however, prices tend to be higher.

The same issue is seen in per diem costs: there are typically cost over-runs in hotel costs (e.g. internet charges) or taxi and meal costs, which are usually never predicted at the budget stage.

But any experienced consultant sees that these are only some of the costs associated with the project:

- Bidding expenses may have included sending the proposal by DHL as well as several telephone calls or even personal visits to understand customer requirements.

- Post-project expenses, which we call Project Closing Expenses, and may include another courier package with a final report and the invoice, and even more telephone calls.

Let's look at our sample project with Bidding and Closing Expenses added in. We call this "Total Project Expenditure", or TPE:

Table 3: Total Project Expenditure (TPE)

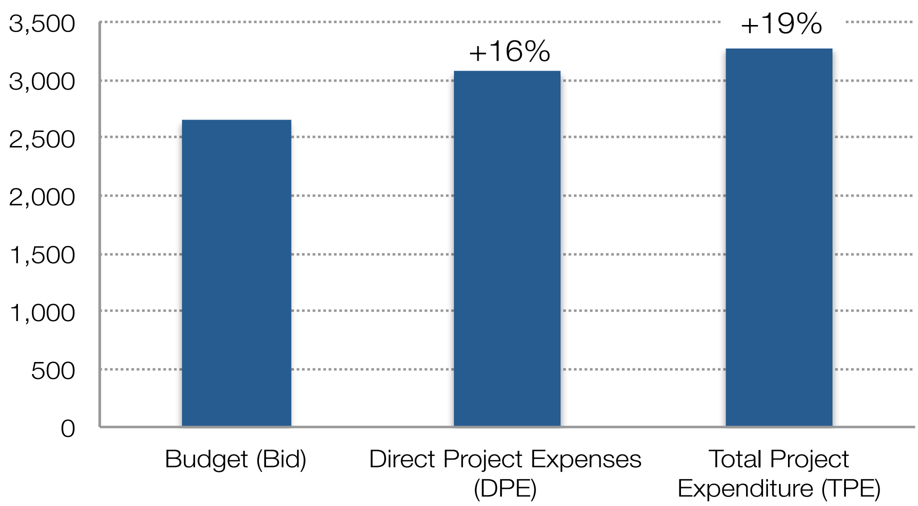
Total Project Direct Expenditure	Amount (EUR)
Bidding Expenses	121
Direct Project Expenditure (DPE)	3,074
Project Closing Expenses	85
Total Project Expenditure (TPE)	3,280

The variation between TPE and the reimbursable expenses in the actual budget are large. As seen in Table 4, the variation between the bid and DPE is +16%, while the variation between the TPE and the bid is +19%.

Table 4: Variation between Budgeted Expenses and Total Project Expenses

Budget (Bid)	2,650
Direct Project Expenses (DPE)	3,074
Total Project Expenditure (TPE)	3,280
Variation (PA:Bid)	+16%
Variation (TPE:Bid)	+19%

All these relatively small amounts start to add up. The problem may seem exaggerated because this is a small contract, but believe me, larger contracts run up unanticipated expenditure just the same way that small contracts do, particularly when consortia or large project teams are involved.



Gross Project Income (without Fees)

Once we can understand TPE, we can calculate gross project income. Total project income (billings) was EUR 10,753 after the discount. Subtracting TPE gives us gross project income of EUR 7,473, as seen in Table 5, below.

Table 5: Gross Project Income Calculation (GPI)

Total Project Income (Billings)	10,753
Total Project Expenditure (TPE)	3,280
Gross Project Income (GPI)	7,473
TPE : Income Ratio	31%
Bid : Income Ratio	25%

The GPI calculation gives us a very real understanding at the top level of why consultancies find themselves struggling with real profitability.

In the original budget, the ratio of project expenditure to total budget was 25%. This is a rule-of-thumb standard used by both donors and consultancies in project budgeting. Yet this rule of thumb contains a significant margin of error. Once TPE is calculated, the TPE-to-income ratio rises to 31%, or 6% of total project costs.

Given how consultancy budgets and expenditure is going these days, 6% is an amount that most consultancies cannot ignore over time. The first step, then, is to understand why and where this variation occurs.

We will continue this logic in Part 2 of this series, Calculating Total Project Effort, next week.

About the Author

Philip Ammerman is Managing Partner of Navigator Consulting Group and ECN, the European Consulting Network. He focuses on strategic development of enterprises, primarily through managing the investment process (due diligence, business planning, risk analysis, scenario planning) as well as through productivity improvements in sales, online marketing, and IT systems and processes.

Philip has implemented over 150 projects in the corporate investment and restructuring field, delivering over EUR 5 billion of invested resources. He has extensive experience in donor-funded procurement, and has acquired and worked on over EUR 32 million in EU-funded projects.

Contact Philip on:

Email: pga@navigator-consulting.com

ECN: https://www.ecn-eu.com/philip.ammerman/europeaid-cv
LinkedIn: www.linkedin.com/in/philipammerman