

# A Consultant's Guide to Profitability

## Part 2: Understanding ABC Pricing and Break-Even Rates

Part 2 of a 3-part Series

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In Part 2, we look at the fundamental issue of billable days needed to (a) implement a project properly, and (b) assure corporate profitability and break-even.

Basically, we need to understand the answer to two questions:

1. How many days should I budget for a project, and
2. How much should I charge per day?

The first part is relatively simple; the second part is more difficult.

### Activities-Based Costing (ABC)

In order to budget a project, most consultancies use a variant of activities-based costing, or ABC. In ABC, we split up the project tasks into discrete steps, and then estimate the time per task per consultant to arrive at an ABC price for the project fees.

While many donor-funded projects mandate a minimum amount of consultant time, it is crucial to do this calculation independently for a number of reasons:

- a. To understand the formal tender basis for your financial proposal;
- b. To understand if you should be bidding for this project to begin with;
- c. To re-create the planning basis your client has used to define a Terms of Reference (ToR).

I'm going to use a slightly more complex example to illustrate this process than the example in Part 1. This example concerns a commercial due diligence project in Russia, which occurs in two cities, necessitating work for a team of 3 consultants.

The ABC project analysis is seen in Table 1, below. The information presented here is a disguised example.

The methodology is simple: using our ABC framework, we list project tasks on the vertical axis and consultants on the horizontal axis. We estimate the number of days per task, and then multiply the total per task and per consultant by an estimated daily rate.

The question of time estimation is largely one of experience: you have to make an informed judgement on how long it will take to complete a specific task, given the work conditions in the specific country, sector and client. This estimate is crucial: it represents the budget you will provide to any potential sub-contractors or internal consultants, as well as your own planning basis for completing the project on time and within budget.

Table 1: ABC Analysis

Project Activity	Work Days			
	PA	MA	CM	Total
<b>ToR 1: Market Analysis</b>				
1.1 Macro Analysis & Forecast	1			1
1.2 Sectoral Analysis & Forecast	2			2
1.3 Competitor Analysis		3		3
1.4 Pricing Forecasts			1	1
1.5 Market Share & Growth Forecast			1	1
<b>Sub-Total ToR 1</b>	<b>3</b>	<b>3</b>	<b>2</b>	<b>8</b>
<b>ToR 2: Internal Analysis</b>				
2.1 Organisational Structure		1		1
2.2 Business Processes		5		5
2.3 Staff Competencies		2		2
2.4 Budgeting & ROI			2	2
<b>Sub-Total ToR 2</b>	<b>0</b>	<b>8</b>	<b>2</b>	<b>10</b>
<b>ToR 3: Reporting &amp; Financial Review</b>				
3.1 Reporting	4	4	4	12
3.2 Financial Model	1		2	3
3.3 Final Presentation	2	1	1	4
<b>Sub-Total ToR 3</b>	<b>7</b>	<b>5</b>	<b>7</b>	<b>19</b>
<b>Total Project</b>	<b>10</b>	<b>16</b>	<b>11</b>	<b>37</b>
Daily Rate (EUR)	1,000	1,000	1,000	1,000
<b>Total Project Fees (EUR)</b>	<b>10,000</b>	<b>16,000</b>	<b>11,000</b>	<b>37,000</b>

Remember: this analysis should be done even if you are bidding for a project where the ToR that specifies the days per position. For instance, the ToR may provide a time requirement by consultant category:

Long-Term European Project Manager:	180 days
Long-Term Local Project Manager:	220 days
Short-Term Senior EU Consultants:	280 days
Short-Term Local EU Consultants:	550 days

It is still necessary to go through the ABC process, allocating time per project task. At the very least, you will have the foundation of your planning documents when you go into the Inception Phase of the project, and can provide a revised, updated time distribution once your initial analysis has been done.

Why?

- Because by comparing your ABC estimates at the bidding and Inception phases, you can isolate sources of estimation error, and improve your planning in subsequent bids;
- Because you can plan consortium activities more properly, particularly if you have to distribute various work tasks (and work-days / fees) between various consortium partners;
- Because you can draft subcontractor and local contractor budgets and ToR more accurately, even splitting between the Inception and regular project phases;

- Because you can spot “bullshitter” partners who insist on disproportionately high time requirements early in the process, substituting them with more effective consultants;
- Because ABC at the bidding stage enables all bid participants to express their time estimates and expectations at the beginning of the process, avoiding potential future problems later on.

No one expects the ABC process to be perfect. But doing it systematically and properly improves transparency and corporate expectations, and will lead to improvements in bidding and contracting accuracy over time.

## Calculating Daily Rates and Break-Even Costs

As I said in the introduction, the ABC is relatively simple. You can agree or disagree on the time needed for specific components of the project but at the end of the day, you will produce an estimate and work with it, making this is a learning process you improve over time.

But what about the daily rate? This is where it gets difficult.

Most consultancies will pitch a daily rate in the bidding stage at an industry average level necessary for competitiveness, and necessary to come within budget (and provide a discount). Few consultancies or individual experts can differentiate between their break-even rate and their optimum billing rate. The next section of Part 2 will deal with break-even analysis.

In order to break even each financial year, you need to assure:

- That your personal costs of living are covered
- That your professional costs are covered
- That your future costs, e.g. pension or retirement, are covered
- That your statutory costs, i.e. your income taxes, are covered
- That you have a steady cash flow, or a cash reserve to cover periods of time when your billing is delayed

Defining these costs is relatively easy. What is more difficult is to understand how many days you will bill during the year to cover these costs—and therefore what your break even rate is.

I'll illustrate the planning process using a simple example: a small, individual consultant working as an independent consultant. (Planning becomes more complicated as firms become larger, but the basic principle is the same). Examples of budgeting are provided below for the different cost calculations for each cost category.

## Personal Costs of Living

If you are an independent consultant, you need to budget your personal costs of living. If you are the owner / manager of a consultancy firm, this line is equivalent to net wage costs, without employer and employee mandatory contributions to social security.

Table 2: Personal Costs of Living

Personal Costs of Living	# Units	Cost/Unit (EUR)	Total Cost (EUR)
Mortgage	12	980	11,760
Utilities & Telecom	12	185	2,220
Food, Clothing, etc.	12	1,000	12,000
Personal Car - Loan	12	350	4,200
Personal Car - Petrol, Maintenance	12	400	4,800
Personal Car - Insurance	1		800
Medical Insurance	1		4,500
Personal Travel, Vacations, Other Costs	1		8,500
Miscellaneous	1		2,500
<b>Total per Year (EUR)</b>			<b>51,280</b>
<b>Monthly Average (EUR)</b>			<b>4,273</b>

## Professional Costs

Your professional costs are the fixed and planned variable costs you have per year necessary to exercise your profession. In the example below, I've included a small office and other expenditure. If you are a consultant specialising in long-term assignments, you probably won't have these costs, but remember to include your un-reimbursed costs in the country where your project is taking place.

Table 3: Professional Expenditure

Professional Expenditure	# Units	Cost/Unit (EUR)	Total Cost (EUR)
Business Travel	12	250	3,000
Computing & Internet Costs	12	150	1,800
Telecommunications	12	150	1,800
Office Rent	12	550	6,600
Office Utilities	12	120	1,440
Professional Memberships	1		450
Stationery & Printing	1		550
Miscellaneous	1		2,500
<b>Total per Year (EUR)</b>			<b>18,140</b>
<b>Monthly Average (EUR)</b>			<b>1,512</b>

## Future Costs

Please remember that you cannot work forever. Many consultants do not calculate their real future pension costs, assuming that they will "strike it rich" somewhere, or sell their company. We believe that in addition to mandatory (state) pensions, every consultant should be actively saving via a private retirement account. These costs are significant.

In the model below, we assume the following case:

- A consultant who is 40 years old, planning to retire at 65 (25 more years of service)
- A life expectancy to 90, or 25 years after retirement at 65
- A desired monthly pension income of EUR 2,000 / month to supplement a state pension
- A real interest cost, after inflation and pension scheme charges, of 2% per year (ambitious)

In order to achieve the EUR 478,302 in capital needed to support pay-outs of EUR 2,000 per month over 25 years, you need to be saving about EUR 1,220 per month. Remember that EUR 2,000 per month in 25 years will be less after inflation.

This is achievable, although difficult in terms of consistent planning over time. But how many of you are actually doing it? And how many of you are actually costing it in your annual budgets?

Table 4: Pension Cost Planning & Expenditure

Private Pension Planning	Indicator
Monthly Income Target	2,000
Years after Retirement (Pension Terms)	25
Real Interest Rate after Expenses, Inflation	2.0%
Years of Pay-in Contribution	25
Monthly Private Pay-In Target	1,220
Total Capital	478,302

Statutory Pension Payments, per Year	12,000
Private Pension Plan, per Year	14,640
Total Pension Costs, per Year	26,640
Monthly Average	2,220

To total pension costs, I've added statutory pension payments per year: these are the social security taxes you are required to pay by law. In most countries, they increase as you grow older. Make sure you are tracking these costs correctly and updating your each year.

Let's also look at the accuracy of your planning:

- How many of you will have paid off your mortgage by the time you retire?
- How many of you will have paid off your childrens' university expenses or other costs by the time you retire? (And if you won't – have you told them?)
- How much will you be spending per year for medical insurance at retirement?

## Statutory Costs (Taxes) and Total Income Required

Now here's the bad news: if we do a preliminary total of your annual break-even costs in the previous three categories, we see that we need to declare an income after professional expenses and before tax of at least EUR 77,920 per year:

Table 5: Statutory Costs and Total Income

Cost Category	Cost (EUR)
Personal Costs of Living	51,280
Pension Costs	26,640
Total Taxable Income	77,920
Tax Estimate at 25% Cover	19,480
Professional Costs	18,140
Total Income needed per Year	115,540
Total Income per Month	9,628

Unless we have taken steps for tax optimisation, most of us will be paying at least 25% of this income in taxes each year, which means a tax bill of EUR 19,480 that you must add to your target annual income. (The actual tax rate will be a bit higher: this is only a preliminary estimate for budgeting purposes).

You must also add whatever professional expenditure you have which is not paid directly by the client – in this example, we have budgeted EUR 18,140 per year.

Conclusions: you need an annual income of EUR 115,540 per year to break-even. This is EUR 9,628 per month.

Remember that this is without a cash reserve to cover payment delays, let alone a major problem such as a divorce or a medical condition which takes you off active project work.

Now comes the hard part.

## Calculating Break-Even per Day

The key to calculating break-even is the answer to a simple question:

- How many days do you bill per month, or per year?

This is not an easy question to answer, particularly over time.

If you remember from Part 1, we discussed the necessity of budgeting not only for expenditure incurred during the project, but also before the project, as bidding expenses, and after the project, as closing expenses.

We need to take these time costs into account, as well as other time costs you may incur during the year. One example of project time costs for an individual short-term project consultant (not a long-term expert) is given below:

In this example, the consultant implemented 6 projects, with a total of 188 billable days. Total days worked, taking into account proposal costs and closing / reporting costs, was actually 210 days.

Table 6: Project Time Estimate

Project	Bidding	Project	Closing	Total
Project 1	1	35	2	38
Project 2	5	62	2	69
Project 3	2	22	1	25
Project 4	1	25	1	27
Project 5	4	32	1	37
Project 6	1	12	1	14
<b>Total Projects</b>	<b>14</b>	<b>188</b>	<b>8</b>	<b>210</b>

So without considering all the other tasks a consultant has to do per year (writing more bids, which are not won; doing annual accounting; professional education and certification; etc), we can at least calculate a basic break-even rate as follows:

Table 7: Break-Even Rate Calculation

Target Income	115,540
Billable Days	188
Break-Even Rate per Day (Income / Billable Days)	615

Table 7 gives us the bad news. Our target annual income is EUR 115,540 per year. Our billable days were 188. That means that our break-even rate was EUR 615 per day in that year.

Remember that this income is for an individual consultant working as a small, single proprietor firm. Partnerships, or married consultants, tend to have greater income (but also greater expenditure in operating costs and taxes).

The break-even results are pretty depressing for most consultants working on EU-funded projects.

Daily rates for short-term EU consultants are universally lower: EUR 500-550 per day is a going average. If you are working on a grant programme such as Leonardo da Vinci or FP7 project, rates are far lower and, absurdly, based on country of residency of the consultant (a sure violation of Single Market rules, if anyone bothered to challenge this).

Long-term consultant monthly rates are usually between EUR 8,000 – 12,000 per month. Most contractors are cutting or absorbing per diem rates, eliminating project apartments, and cutting any excess spending, particularly since competition is increasing and the bidding success rate is falling.

Any delay in payment, any medical condition which necessitates taking time off, or any other financial issue, results in a catastrophic impact on earnings. Most consultants avoid this by cutting back on retirement or medical insurance, by working from home, etc.

There are a number of strategies for dealing with the issue of billing low daily rates in a high cost environment:

- Form a consultancy partnership to combine the cash flows and income of multiple earners
- Engage lower-cost consultants to do project work and bill them at high rates
- Find other clients whom you can charge higher daily rates
- Migrate offshore, which may have legal and ethical implications
- Unilaterally increase your rates, and refuse contracts which don't offer them
- Reduce whatever fixed costs you can, e.g. by renting flexible office space or moving to a cheaper location
- Move a greater share of personal expenditure into professional expenditure, so it can be deducted from taxes (there are limits to this as well).

But the trends and process should be clear: in order to understand annual break-even rates, you need to model all costs incurred and anticipated, and divide by the number of realistically-anticipated billable days.

We strongly recommend that every consultant or consultancy implement such an analysis: the results will be illuminating.

Part 3, next Friday, will discuss managing portfolios of projects and cash flow.

## About the Author

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