A Consultant's Guide to Profitability

Part 3: Using the Cash Flow Cycle and Effective Daily Rate Model to Understand your Business

Part 3 of a 3-part Series

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In Part 3, we reflect on the general financial set-up of the consulting profession, and of portfolios of consultancy projects. This ties together the cost accounting and billing principles we covered in Parts 1 and 2, and raises some important questions about the sustainability of the consultancy profession, particularly as it is practised in donor-funded projects or "technical assistance" consulting.

The Cash Flow Cycle (CFC) and Effective Daily Rate (EDR) Model

A long time ago, I read Womack & Jone's Lean Thinking, and a little while later James Collins' Good to Great. These two books focus on what performance and excellence actually mean in practise, and the role strategic benchmarking plays in creating and sustaining world-class companies. These are still excellent books today, and if you haven't read them, I strongly recommend doing so.

These got me thinking about the consulting sector, and why it seemed so difficult to do brilliant consulting work and earn a decent living at the same time, particularly within the donor-funded project universe.

My thought process at the time was trying to solve two basic questions that our company had confronted since our foundation in 1995 (about 5-6 years before I read these books):

- Why did we always seem to be out of money even though we had lots of projects?

- What types of daily rates should we be charging, and how many should we be charging, in order to avoid the cash flow problem and also attract and retain the talent we needed to grow?

Trying to solve these two questions led me to define a very simple metric for measuring the success of our consultancy operations: the Effective Daily Rate / Cash Flow Cycle analysis. In order to run this, you need three core metrics:

- Your corporate (or individual) break-even rate, which we calculated in Part 2
- Your cash flow cycle per project, which we introduced in Part 1, and re-calculate here
- Your effective daily rate (EDR) as opposed to your Invoiced Daily Rate (IDR).

Cash Flow Cycle

Project Cash Flow Cycle (CFC) is calculating from the moment significant expenditure is first incurred on a project (i.e. at the bidding stage) until the moment when the project has been totally paid off by the client.

Cash Flow Cycle is primarily a measure of how quickly it takes to get paid for a project. This enables you to make two qualitative / quantitative evaluations about your business:

a. How good are your clients when it comes to paying?
b. What provision do you need to make per month or per year for a cash flow reserve?

In Part 1, we talked about Total Project Expenditure, while in Part 2 (Table 6: Project Time Estimate), we saw that consultant hours spent on preparing bids are a significant expenditure. These same two factors are integrated into Cash Flow Cycle monitoring, as seen in Table 1, below:

Table 1: Cash Flow Cycle (days) – Sample Projects

Project	Bid	Project Start	Project End	Final Payment	CFC (days)*
Project 1	02 February	12 March	15 June	15 July	164
Project 2	26 March	17 March	19 June	28 June	94
Project 3	05 May	06 September	15 October	15 November	194
Project 4	12 June	18 June	02 August	05 September	85
Project 5	17 July	29 July	16 October	12 December	148
Project 6	22 July	05 August	22 September	12 October	82

** To calculate the cash flow cycle, format your Excel cells in days, and then simply subtract the Bid Date from the Final Payment Date. This provides you with calendar days: you can choose work days over calendar days or use months instead of days using a simple formula in a next column. In this example, we assume all projects fall within a single year: if they do not, use the custom cell formats in Excel to include the year.*

As seen from Table 1, the Cash Flow Cycle is long. In multi-year donor-funded projects (e.g. EuropeAid or USAID projects), the cycle may last for years. We use a rule-of-thumb for EU grant programmes (such as Leonardo da Vinci or FP7) that:

- You write the proposal in "month 1"
- You receive approval to start and a down payment in "month 12"
- You finish the project 2 years after project start, i.e. "month 36"
- You complete the final report and receive the final payment in "month 48" – a full 4 years after you have first incurred significant expenditure in proposal writing.

We believe it's necessary to track total expenditure from start to finish. This is because of a number of mainly operational reasons:

a. All projects take management time; major projects take major management time. Even if a project cash flow is considered "manageable" or "doable", there is still a legal commitment upon the partners of the firm to complete the project successfully and close the books.

b. Many projects require a bid guarantee and a performance guarantee if the project is awarded. Other projects have to be pre-financed. In either case, the partnership incurs real financial costs as well as opportunity costs.

c. Our clients expect us to perform on time and to specification. In turn, we want clients who respect our need to get paid on time. This is something usually lacking from the European public sector.

As an alternative, you can track the cash flow cycle between project payments, rather than from start-to-finish. But we believe start-to-finish is best.

Effective Daily Rate (EDR) versus Invoiced Daily Rate (IDR)

The next step is to understand the difference between your Effective Daily Rate (EDR) and your Invoiced Daily Rate (IDR). In order to do this, we need to combine the analysis we did in Parts 1 and Part 2.

Table 2: Effective Daily Rate Calculation per Project

Budget Calculation in Bid (before discount)	12,650
Total Project Income (after discount)	10,753
Total Project Expenditure (TPE)	3,280
Gross Project Income	7,473

Days Invoiced (under Contract)	10
Invoiced Daily Rate (under Contract)	1,000
Total Fees	10,000

Actual Days Worked:	Days
1. Bidding	1
2. Training Preparation	2
3. Implementation	10
4. Closing	1
Total = Actual Days Worked	14

Original Budget	12,650
Discount Offered	1,898
Total Project Expenditure (TPE)	3,280
Gross Project Income	7,473

Effective Daily Rate	533.75

In Part 1, Tables 1 and 5, we gave the example of a blended learning programme for a Chamber of Commerce and Industry. The total budget was calculated at EUR 12,650, and a 15% discount was offered, bringing the actual income down to EUR 10,753. After total project expenditure, the gross project income was EUR 7,473.

In the original proposal, we were going to bill 10 days at EUR 1,000 per day, for EUR 10,000 in total fees. So our Invoiced Daily Rate (IDR) was EUR 1,000.

In Part 2, Table 6, however, we saw that the actual time spent on all projects was greater. In this table, Project 6 (which corresponds to the Chamber of Commerce project) had 1 day of bid preparation, 12 days of project work, and 1 day of closure time. Of the 12 days of project work, 2 days were training preparation (which were not compensated by the client), and 10 days of actual work (2 days training; 8 site visits).

Thus, our actual days worked were 14: 1 day to bid; 2 days to prepare; 10 days to implement; and 1 day to close. So let's turn back to our project budget:

- We recorded a gross project income of EUR 7,473
- We worked 14 days to implement the project
- Our Effective Daily Rate (EDR) is gross project income divided by 14 days, or EUR 533.75.

This is actually below the break-even rate in this example, which we calculated at EUR 615 per day. The ratio of EDR : IDR is only 53%. By any measure, we have worked nearly twice what we were paid for in this project. I'll comment more on this under Profitability Strategies, two sections from now.

Plotting CFC and EDR

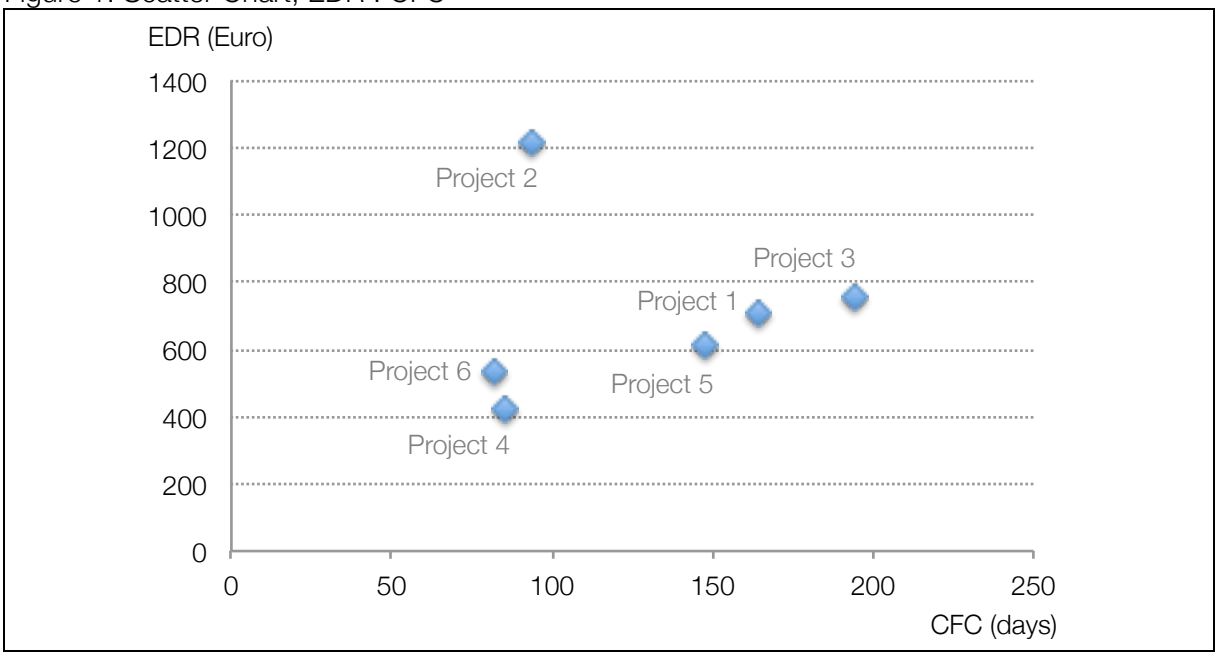
So how does this EDR / CFC model help us? If we implement the analysis for each project in our portfolio, and then calculate the portfolio average, we receive a list of 2 data points per project, as seen below:

Table 3: Portfolio EDR and CFC

Project	EDR	CFC
Project 1	712	164
Project 2	1214	94
Project 3	753	194
Project 4	425	85
Project 5	615	148
Project 6	534	82
Portfolio Average	709	128

We can therefore plot each project data point in a scatter chart, as seen in Figure 1:

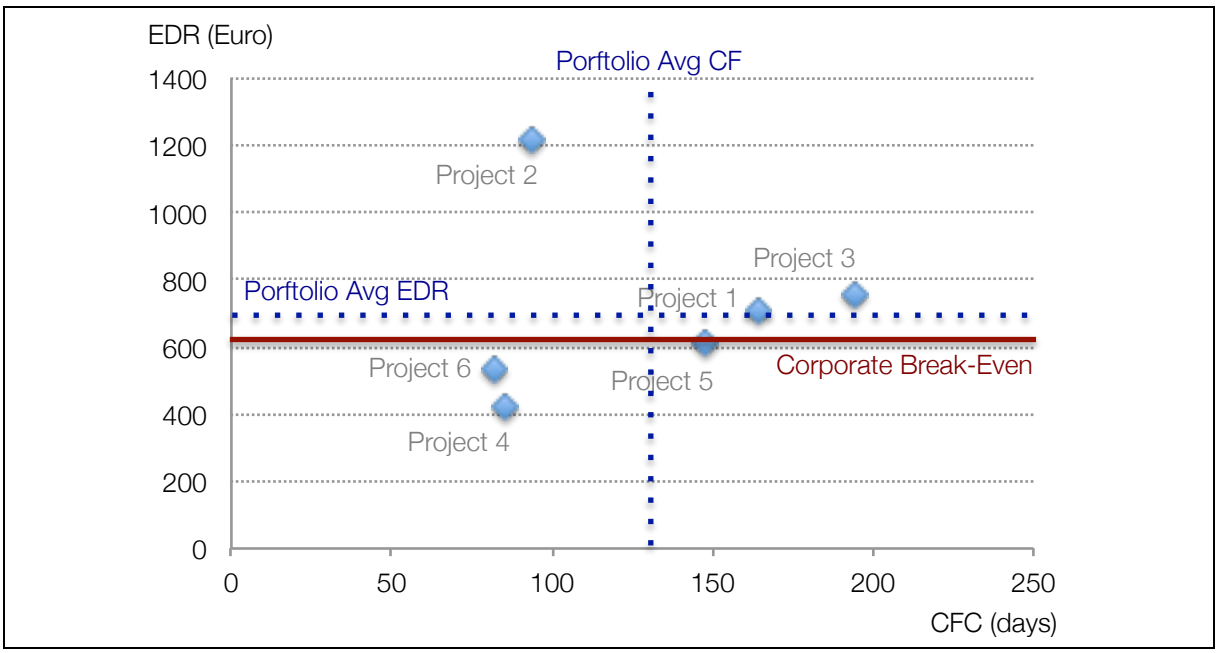
Figure 1: Scatter Chart, EDR : CFC*



**I always prefer to plot CFC on the X-axis, because this gives me the understanding of a linear time sequence, and I always prefer to plot the EDR on the Y-axis, because it's easier to understand which EDR represents greater income for the firm. Another option is to use bubble charts, with the area of the bubble representing either total project billings or gross project income.*

When we manually add lines (in Powerpoint) representing the corporate break-even and the portfolio averages, we have a strategic quadrant, as seen in Figure, 2 below:

Figure 2: Break-Even and Portfolio Averages



The top left quadrant is obviously the "sweet spot" – high EDR, fast payment schedule. The company should focus on this quadrant as far as possible, either doing more projects for the same client, or similar projects for similar clients.

The bottom left quadrant is a problem: fast payments, but an EDR below break-even. The firm needs to bill more, or reduce work, or adjust direct costs and overheads to continue competing here.

The top right quadrant is interesting because of high EDR, but completion and payment are taking time. Bids need to be adjusted to take into account the high cash flow cycle, and efforts should be made to close projects faster. The question of whether the CFC delays are due to client procedures or consultant performance needs to be examined.

The bottom right quadrant is difficult no matter what. This represents projects below break-even, and which take a long time to complete and pay. Lots of questions need to be answered for projects (and clients) in this quadrant.

This analysis can also be repeated as follows:

- By client, not by project. If you add the client name instead of the project name, you typically gain very clear resolution over who the problem clients are.

- By consultant: if you have the data needed to isolate individual consultant performance, e.g. by tracking the number of billable days versus days worked, you start seeing very interesting information over the performance of your team members.

Typically companies (and individual professionals) don't have a great deal of choice in the projects they take on—at least not in the short term. The value of the EDR / CFC model is that it helps you understand project, client and consultant performance over time. It forces you to question not only whether you are working for the right clients, but whether your own performance and break-even costs are suitable for your professional and corporate development.

Before going on to a description of potential profitability strategies, I want to cover three other points which wreak havoc with consultancy profitability: Inflation, Competition and Service Saturation.

Inflation in a Fixed Fee Rate Environment

We've all learned about inflation, but few of us are really doing anything about it when it comes to our own consultancy practise. When you are working for the donor sector, fee rates are typically fixed, or may even be declining due to competition and saturation (see next section). Achieving profit in this environment becomes difficult.

In the UK, for instance, official consumer price inflation between 2000 and 2010 has risen by 23%. Let's see how this impacts the salary of a permanent staff member in London.

We assume a net starting salary in London in 2000 at EUR 5,000 / month, and adding in 28% social security contributions and 25% of net salary as direct overheads. If we increase this in line with inflation, the total employer costs would have risen from EUR 7650 per month in 2000 to EUR 9,414 per month in 2010.

Assuming 22 working days per month (factoring in weekends, national holidays, vacation time and sick leave) means that the daily employer rate rose from EUR 348 per day in 2000 to EUR 428 per day in 2010.

Table 4: Standard Inflation Adjustment on a Consultant Salary

	2000	2002	2004	2006	2008	2010
HICP (Eurostat)	0.8%	1.3%	1.3%	2.3%	3.6%	3.3%
Net Salary	5,000	5,126	5,265	5,499	5,828	6,153
Social Security (28% net)	1,400	1,435	1,474	1,540	1,632	1,723
Overheads (25% net)	1,250	1,281	1,316	1,375	1,457	1,538
Total Employer Costs	7,650	7,842	8,056	8,414	8,917	9,414
Employer Cost (EUR/day)	348	356	366	382	405	428

But what consultancy can afford to pay a consultant merely in line with inflation over 10 years? This calculation ignores:

- Salary rises due to seniority and performance bonuses
- The fact that the "real" inflation rate, if one considers housing prices and the UK Pound devaluation against the Euro, is far higher.
- The fact that the Invoiced Daily Rate has been falling dramatically. We estimate that average EU project IDR has fallen from about EUR 850/day in 2000 to about EUR 725/day in 2010 (see Table 5), and will probably continue to fall in the future.

We estimate that the real annual employer cost increase between 2000 and 2010 is about 10% per year. The UK recession (which has not yet manifested any difference in CPI) is leading to a rate decline among freelance consultants and new labour market entrants, but so far not among the highly qualified, specialised consultants any consultancy needs to compete.

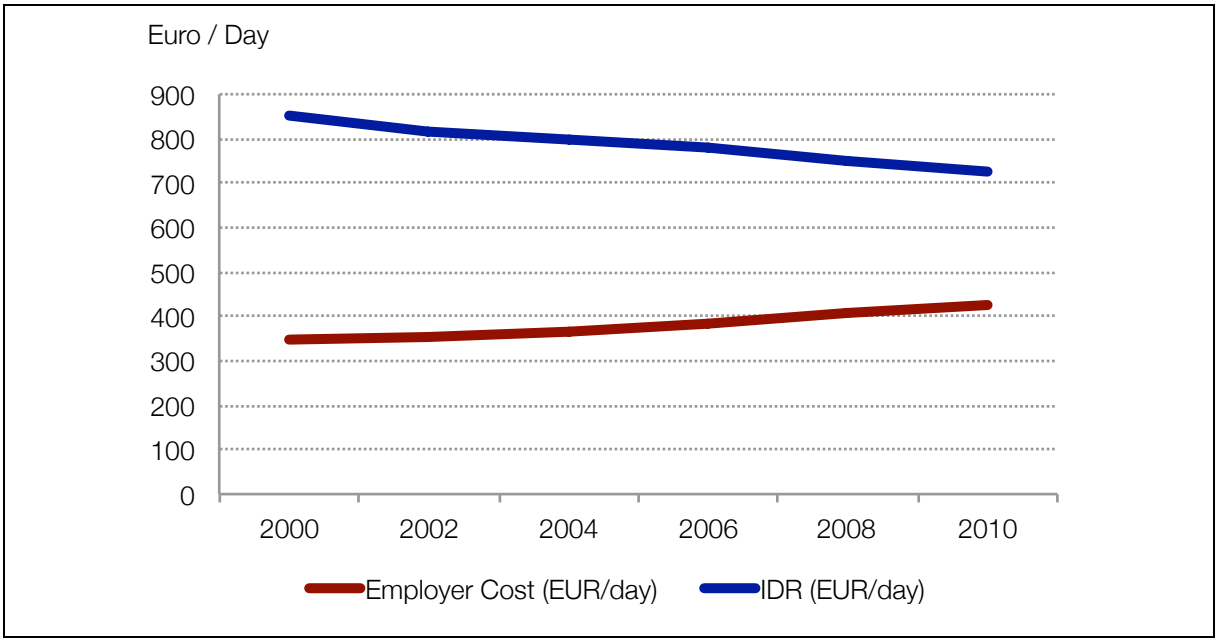
Give that EU fee rates remain fixed, and are even declining due to competition, it becomes clear that a consultancy that really wants to invest in the quality of its services, or a consultant that wants to earn a living wage sufficient to live in a major city in his home country, faces major challenges.

Table 5: Employer Margin Analysis

	2000	2002	2004	2006	2008	2010
Employer Cost (EUR/day)	348	356	366	382	405	428
IDR (EUR/day)	850	815	795	780	750	725
Employer Margin (EUR/day)	502	459	429	398	345	297

Table 5 and Figure 3 illustrates the shrinking overhead margin between the average Invoiced Daily Rate (IDR) and the employer cost/day for a full-time consultant under the inflation-adjusted model. This is a conceptual chart rather than one using real statistics, for illustration purposes.

Figure 3: Margin Shrinkage between Invoiced Rate per Day (IDR) and Employer Cost/Day



This margin is also shrinking due to the massive increase in indirect taxes. In 2000, for instance, most EU countries had a value-added tax (VAT) for services which was below 10%. Today, VAT amounts to between 15-23% on services in most jurisdictions. Although many people will argue that VAT for companies is merely a cash flow issue, it is one of many additional challenges to a consultancy operating in a high cost environment. Certainly for individual professionals, where VAT may not be recoverable, it is a major factor.

There are a number of additional indirect taxes which have pushed up the cost of living:

- "Solidarity Taxes" as part of social security or payroll taxes: In most countries, particularly France and Germany, a solidarity tax has been introduced. This initially started low, e.g. at

1.5-2% of payroll taxes, but many governments have increased this significantly, to the point where it may now amount to 7-8% of payroll taxes.

- Council Taxes or Taxes on Property: European governments are resorting to taxing property in an effort to balance their budgets. As property prices have risen (particularly in cities such as Paris, Amsterdam, London or Stockholm), the property taxes have risen significantly. It is now a major question whether a consultancy will own or rent a property, but in any case, the property tax must be paid.

- Energy taxes: this is one of the most regressive set of taxes around. Taxes on gasoline have increased to the point where in many countries, the VAT and tax components on gasoline exceed the actual fuel costs per litre. Electricity taxes have also risen, usually due to the inclusion of a renewable energy tax on households and companies: this tax is used to partly-finance the feed-in tariff for renewable energy investments.

There are many more examples: I've only selected a few which are probably representative across many countries.

Some cost elements have definitely gone down: travel, communications and information technology, for instance, have definitely all gotten cheaper. In many countries, the corporate income tax has also fallen.

The impact of indirect price rises in taxes and property, however, together with falling fee rates charged and the bankruptcy of most national healthcare and pension systems, means that overhead costs are rising higher than daily rates (which are not rising at all) and profit margins in most countries in the European Union.

Fee Rates and Competition

We have briefly seen the impact of fee rates and competition in the previous table. To summarise our experience: we see both the Invoiced Daily Rate declining from about EUR 850/day in 2000 to between EUR 680-750 per day in 2012 (I've used an average of EUR 725 in Table 5). These figures do not include per diem costs (see note below).

These fee rate declines are a result of the following factors:

a. Contractors are offering far greater discounts to win projects. When I started working in Germany in the EU-funded consulting sector in 1993, we would offer a discount of between EUR 50,000-70,000 on a EUR 1,000,000 contract. Today, that discount has grown to about EUR 120,000 – 180,000 in some cases. We now see several lower cost competitors offering a 20% standard discount.

b. The EU now requires a greater allocation of project budgets to local consultants. While the fixed share in a project budget may be the same (usually between 15-30%), the rates of local consultants have risen in many cases, requiring various contortions between project budget shares.

c. A huge class of EU freelancers working and living in emerging markets has arisen. Rather than employing high-cost permanent staff from home markets, large contractors are employing freelancers at lower rates, and paying them far lower daily fees.

d. The EU expansion in 2004, which brought Poland, Hungary, the Czech Republic, and seven other countries into the EU, instantly transformed consultants who had been "local consultants" prior to 2004 into "EU" consultants, enabling further cost savings to contractors at the expense of consultants from Germany, England, France and other more expensive countries.

e. Tender competition has increased dramatically. While a 20% success rate on Tacis or Phare tenders has possible in 1995-1999, a EuropeAid success rate of 10-15% in 2011 is considered stellar performance. Many companies are reporting far lower success rates, on the order of 1 win for every 12 or 15 tenders submitted.

As a result of this competition, we see a good deal of "cannibalism" in the EU consultancy sector:

- Contractors are not only paying lower rates to sub-contractors, but are also withholding the full per diem or travel budgets to the front-line consultants. Budget items such as flight costs and per diem costs are "absorbed" (embezzled would be a better term) by the contractor.

- Contractors outsource most functions, from project management to staffing, and specialise solely in bidding, client relationships and cash flow management.

- There is practically no quality assurance or continual staff development in technical assistance, except the minimum needed to get by under project cycle management and the "Logical Framework". This applies to both the contractors as well as to freelancers.

- The financial crisis is causing major problems, as banks no longer extent "paper" bank guarantees for project advances, and large contractors face major problems in financing projects.

To summarise: we hardly believe that "consulting" as it is practised by many contractors, with the full awareness and compliance of the European Union, should actually be called consulting. It's mainly an exercise is subcontracting or personnel administration which contains massive risks for project quality and results.

Service Saturation

The impact of competition is seen not only in terms of client-related competition, but also in terms of service saturation.

We don't have primary data of our own here, but I will rely on very reliable data from a friend who owns one of the largest specialised consultancies in a peripheral EU Member States. In this case, the service involves ISO 9000 certification.

In 1992, when he started his consultancy, the consultant price for an ISO 9000 certification preparation was about $ 20,000 – 25,000, which in the days of ECU (the European Currency Unit, the forerunner to the Euro) might have been as much as EUR 32,500. The fact that his country used a local currency priced far below either the ECU or the USD made this a very profitable practise indeed at the time.

The rather extreme example of what happens next has been repeated in a number of public sector consultancy practises, although perhaps not to this extent.

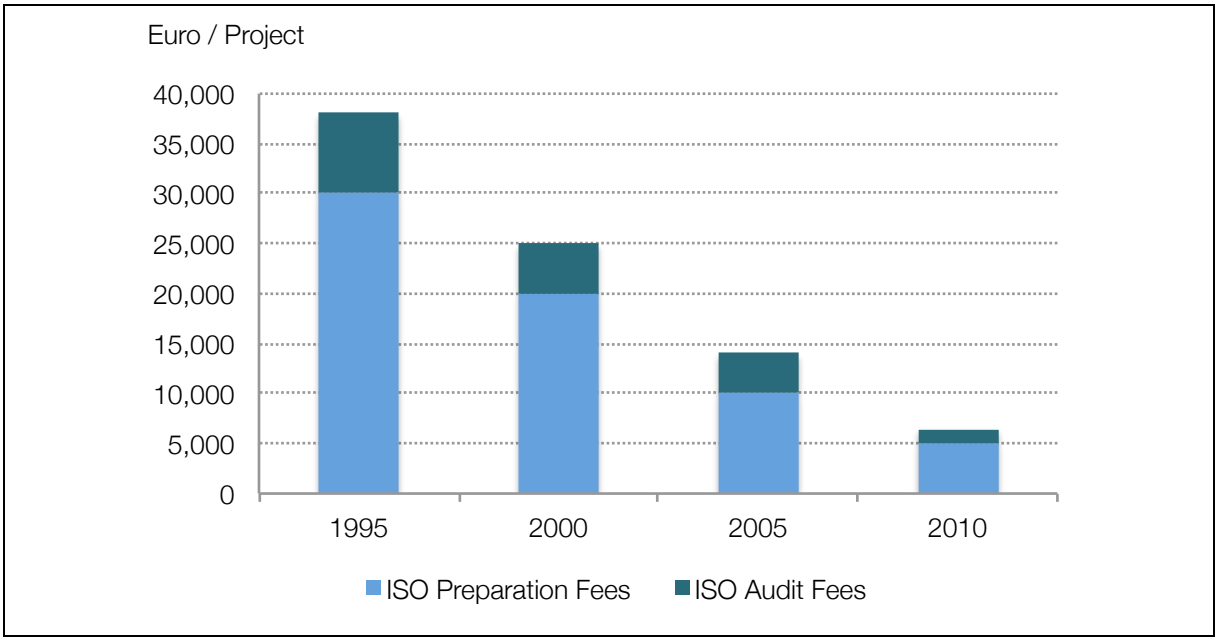
In order to support manufacturing and service quality, the government of this peripheral country decided to channel tens of millions of Euro every year into quality assurance with the aid of EU Structural Funds. As a result, ISO consultancies blossomed. From about 15-20 "real" consultancies in the entire country, within 10 years there were hundreds if not thousands of consultancies offering ISO preparation services.

Table 6: ISO Fee Change, 1995-2010

Sample Prices	1995	2000	2005	2010
ISO Preparation Fees	30,000	20,000	10,000	5,000
ISO Audit Fees	8,000	5,000	4,000	1,500
Total ISO Costs	38,000	25,000	14,000	6,500
Change in Prep Fees (y-o-y)		-33%	-50%	-50%

By 2005, for instance, the cost of an ISO preparation had fallen to about EUR 10,000, and by 2010 to about EUR 5,000. By 2012, with the financial crisis in full swing, not only had prices fallen to about EUR 4,000, but the clients very often could not actually pay their invoices.

Figure 4: ISO Fee Change, 1995-2010



As stated, this is an extreme example. But as any consultant knows, there is a "service lifecycle" to consulting:

- A new idea, such as business process re-engineering (BPR) or Toyota Production System (TPS) hits the market. Initial contracts at multinationals or banks or public sector organisation go for swingeing prices – usually over EUR 1,000,000.

- Five years on, everyone and their brother are offering the same service. Prices have fallen by 30%.

- Five years after that, the European Commission or some government announces the "National European Health and Safety Strategy", and start throwing billions of Euro in

complex, multi-year strategies. Universities and vocational training institutes everywhere start offering bachelor's, master's and PhDs in the sector.

- Five years after this, the sector has collapsed and no one can remember what the craze was even about in the first place.

Sound familiar? I exaggerate, but having seen such concepts as Total Quality Management morph into mandatory EU standards for HACCP and ISO in the food processing sector, putting thousands of artisanal food producers out of work (or turning them into experts in EU subsidy programmes), it's difficult to feel a sense of idealism in progress.

ISO is an interesting example of consulting service lifecycle in this respect. The craze started in the early 1990s as ISO 9000 for quality management systems. That apparently was not enough, so ISO 14000 for environmental management systems emerged. This was followed by ISO 18000 for occupational health and safety. The ISO 17000 series for laboratory management systems became in vogue. I understand that the hottest thing in the sector right now is ISO 27000 for information security standards.

Part 3 must end now, but in a supplement I will provide further information on different strategies and response tactics that can be used to regain or develop profitability.

About the Author

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