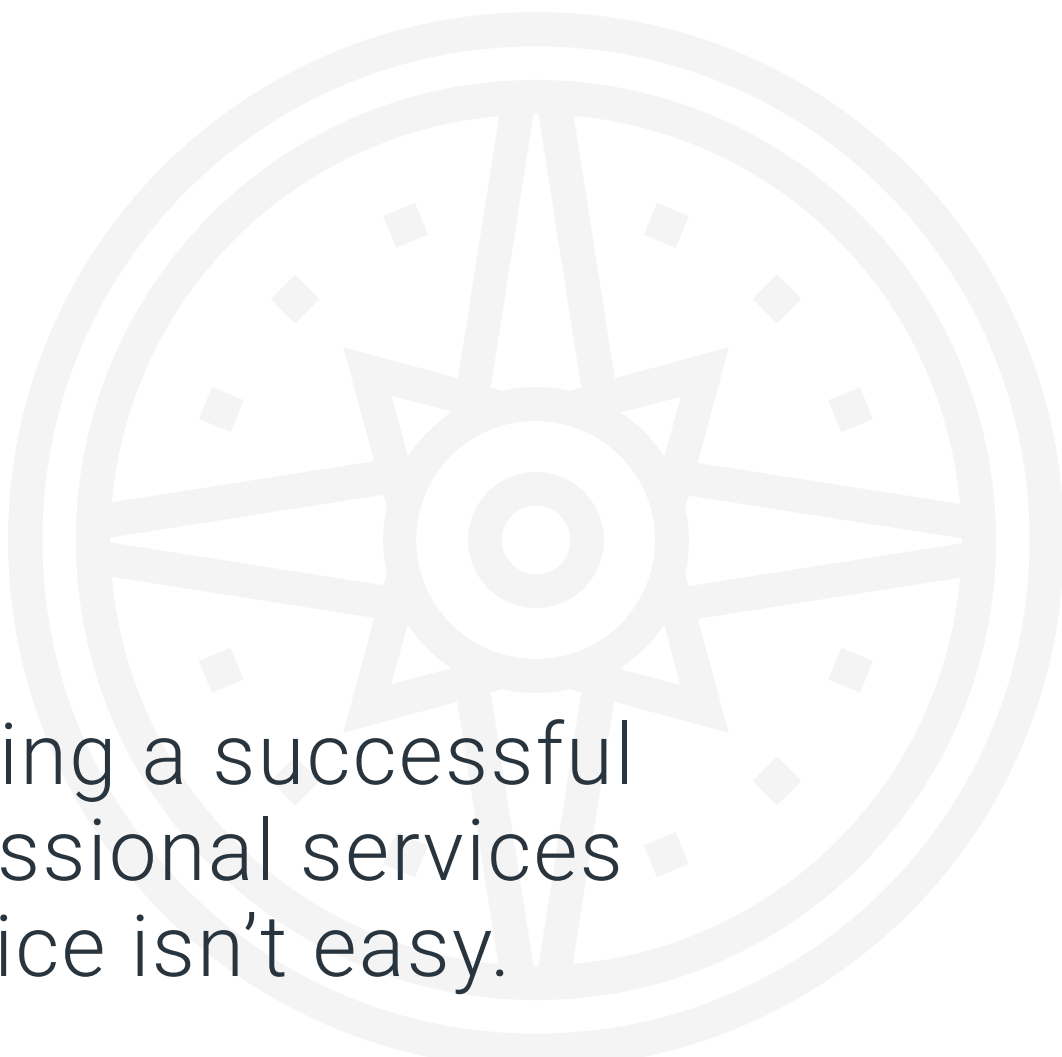




## COMPASS

Help your  
professional services  
team navigate toward  
better performance.



# Growing a successful professional services practice isn't easy.

This is largely due to the variability of engagements, clients, and employees found in most firms. But, once you understand some key concepts and management techniques, the journey becomes far less daunting. Compass is a free resource that was created to help you improve the performance of your professional services operation. If you have thoughts about how we could improve Compass, just shoot us an email at [compass@ruddr.io](mailto:compass@ruddr.io).

The typical financial goals of services firms, and most other companies for that matter, are to grow revenue and improve profit margin. Most professional services firms accomplish these goals sporadically, but only the best do so consistently. Why? The underperformers tend to wander from project to project with limited controls and processes in place while the leading firms meticulously leverage best practices and a robust suite of tools.

Compass will guide your professional services voyage and help replace the periodic chaos in your business with more predictable performance. Compass starts with the fundamentals and then covers the five key components of running a professional services organization: sales, client satisfaction, employee satisfaction, productivity, and efficiency.

<b>CHAPTER 1</b>	What are Professional Services?	04
<b>THE FUNDAMENTALS</b>	Characteristics of Professional Services Companies	06
	The Business of Satisfaction	10
	A Delicate Balancing Act	12
	Key Performance Indicators	13
	Interpreting Financial Statements	16
<b>CHAPTER 2</b>	Start in a Niche	20
<b>SALES</b>	Marketing for Professional Services	24
	The Sales Pipeline	30
	Basic Best Practices	33
	Provide Clients with Options	38
	All Revenue is Not Created Equally	40
	Forecasting	42
	Bookings vs. Billings vs. Revenue	44
	Estimation	46
	The Legal Stuff	49
	The Trusted Advisor	51
	Invest in Existing Clients	53
	Sales Team Compensation	55
<b>CHAPTER 3</b>	Satisfaction is about Experience and Expectations	59
<b>CLIENT SATISFACTION</b>	Understanding Value Delivery	62
	Net Promoter Score for Professional Services Firms	64
	The Relationship Equity Piggy Bank	66
<b>CHAPTER 4</b>	Work-Life Balance	69
<b>EMPLOYEE SATISFACTION</b>	Culture as a Competitive Advantage	73
	Performance Evaluation with OKRs	75
	The Anonymous Employee Survey	77
<b>CHAPTER 5</b>	Utilization	80
<b>PRODUCTIVITY</b>	Revenue Backlog	84
	Understanding Leverage	86
	Delivery Team Optimization	90
<b>CHAPTER 6</b>	Managing the Bench	95
<b>EFFICIENCY</b>	Effective Bill Rates	97
	The Most Important Role on a Project Team	99
	The Importance of Process	102
	Gross Margin	105



## CHAPTER 1

# The Fundamentals



## CHAPTER 1.1

# What are Professional Services?

Professional services companies provide high-skill services to customers (who are typically referred to as “clients”) for a fee. There are many types of professional services companies with areas of expertise ranging from accounting to legal to marketing. Professional services firms in the United States generate an estimated \$2 trillion in revenue annually and account for roughly 10 million jobs.

A defining characteristic of professional services firms is customization - the work they deliver is often tailor-made for each client. Firms hire and train skilled workers who then leverage their expertise to provide these customized services and deliverables. It is this ability to deliver high-quality, individualized services that creates, and sustains, tremendous economic opportunity for professional services firms.

Clients typically engage a professional services company because they lack the expertise or capacity to deliver a service internally within a desired timeframe. When a company hires a law firm, for example, it’s usually because the company doesn’t have in-house counsel. It would be too risky for company leaders to draft their own legal contracts, so they eliminate that risk by hiring a capable law firm.

In other cases, a company may have the expertise within its ranks to handle a project internally, but lack the available personnel to complete the work within the needed timeframe. Many large companies have an army of marketers and software developers, but still leverage outside professional services firms in these same categories to complete key projects sooner.

In a nutshell, companies hire professional services firms to attain high-quality, customized services and deliverables, with low risk and in a reasonable period of time. To achieve these goals, companies are willing to pay a premium. As you engage with your current and prospective clients, it is important to keep their core needs in mind. Remember: high quality, low risk, quick turnaround.

## The Difference Between Consulting & Professional Services

The terms “Professional Services” and “Consulting” are often used interchangeably, but they are not the same thing. Consulting is a type of professional service. Professional services is the macro category that includes a wide range of services industries, including various types of consulting.

Consulting services usually involve an advisory component. Consulting firms provide clients with strategic guidance in an area where the firm has deep domain expertise. Management consultancies, for example, often provide strategic counsel to the client’s leadership team in an effort to improve the client’s business performance.

Many types of professional services do not include this advisory component. For example, a software product company may have a services division that installs the company’s product. Those personnel aren’t providing consultation to their customers; they are engaging in tactical implementation activity. So, while all consulting firms can be considered professional services companies, the reverse is not true.

This raises the question – why are these terms used interchangeably when consulting is actually a type of professional service? There are a couple of reasons. First, many professional services companies include some amount of consultation as a part of the service delivery. Second, “consulting” is a shorter term than “professional services” (three syllables instead of seven) and brevity usually wins.



## CHAPTER 1.2

# Characteristics of Professional Services Companies

The following are some common characteristics that apply to most types of professional services companies.

## These are People Businesses

Professional services firms are extreme versions of “people businesses”. A people business is one in which the revenue is generated directly from the labor of the employees. Unlike a product business, a people business must grow headcount to scale revenue.

With a people business, the quality of the services delivered to clients is entirely dependent on the team of people assigned to the work. Within the same firm, a project could have wildly different outcomes depending on the specific people assigned to the project roles. This is why effective resource allocation is one of the most vital tasks within a professional services company. The wrong combination of people on a project will yield a dissatisfied client and often a poor economic result for the firm.

## Easy to Start, Hard to Scale

Professional services businesses tend to be easy to start and hard to scale. They are easy to start because you only need to possess an in-demand skill and a client or two willing to pay you for that skill. This has become easier than ever given the numerous job boards available and the prevalence of digital freelance marketplaces. More and more professionals are “hanging out a shingle” and starting their own services business.

Unlike product businesses, you can begin to capture revenue almost immediately with a professional services business. You don’t have to wait for a long research and development

effort to finish before you can start generating cash. In fact, you may not need to raise any capital at all to get a services business off the ground. You can incorporate the business, start working for clients, and begin invoicing those clients all within the first month.

But, as easy as these firms are to start, they are fairly difficult to scale. Why? Because they are people businesses. To scale a people business well, you must possess an entirely separate set of skills than the ones you use to deliver the underlying service to clients. In order to grow your firm, you must create an appropriate organizational structure, hire the right employees, develop and document repeatable processes, train and manage employees, leverage the right operational tools, track dozens of metrics, and so forth. The majority of professional services firms remain small simply because of the compounding complexity that comes with headcount growth.

## Firm Structure

There are two common structural models for professional services firms. The first is the “guru model”, in which the firm is comprised of seasoned experts who need very little training or direction in order to deliver high-quality services to clients. The most classic example of the guru model would be a management consulting firm with 20-30 partners who are all experts in their area of focus. The second model is the “leverage model” in which the firm is comprised of all levels of experience, including hires directly out of college. Some firms start out with the guru model and then migrate toward the leverage model over time.

The guru model firms often remain smaller and are easier to manage. Since all of the employees (or partners) are highly experienced, they don’t need much in the way of training, managing, process documentation, and the like. They understand that their job is to sell engagements and then deliver services on those engagements. In many ways, each partner in a guru model acts as the CEO of his or her small portion of the business. With a guru model, bill rates tend to be very high and so are the salaries of the team members.

With a leverage model, the firm hires all levels of employees and needs better process maturity. Since it hires college graduates (with no experience), the firm must have a robust training program and well-documented service delivery practices. While a guru model could have a 100% remote workforce, the leverage model likely requires office space so that junior personnel can learn more easily from senior employees.



The key to success in a leverage model is to get the new hires trained and highly billable as quickly as possible (ideally within the first year). Since those employees will still have relatively low salaries, the company can generate high profit margin (leverage) over those first several years of employment.

There is no “right” model, but there are major implications of each. It is important that the founders of the firm are clear about the type of company they are building and the model they wish to pursue. Accidentally wandering down the leverage model path with a team that is only comfortable operating under the guru model will not work out well. We have a dedicated topic on leverage later in Compass.

## Billing Models

The vast majority of professional services firms bill their clients on either a “Time & Materials” or a “Fixed Fee” basis.

Time and materials billing (or “T&M”) simply means that the firm will bill the client for all hours worked on the project. The firm likely provides some type of time and cost estimate in the project proposal and, as hours are worked, they are billed to the client (often on a monthly basis). The “materials” part of T&M simply means that any materials purchased or expenses incurred by the firm in the delivery of the services will be charged back to the client for reimbursement.

With fixed fee billing, the client is usually charged a predefined amount of money upon specific milestones or dates. With these types of engagements, it doesn’t matter how many hours the firm works to produce the services and deliverables. If the firm can complete the engagement in fewer hours than planned, its profit margin will be better than expected. But, if the hours run over, the profit can disappear quickly.

With both T&M and fixed fee billing, it is common for professional services firms to bill incurred expenses back to the client. The types of expenses that can be charged back and the total expense budget are usually defined in the legal contract.

## Staff Augmentation versus Project Work

Most professional services engagements fall into one of two macro categories: project work or staff augmentation. With project work, the firm is hired to deliver a specific scope of work

and produce one or more defined deliverables. Projects are finite in length and have a clear set of objectives that must be accomplished for the project to be considered complete. With staff augmentation, a client procures the services of one or more employees from the firm for a longer period of time and often without much scope definition.

These two categories of services work are quite different. Project work tends to be shorter in length and requires specialty skills in certain roles. Given this, the bill rates for project work tend to be much higher than staff augmentation work. With staff augmentation engagements, the client is often looking to expand the throughput and skills of their existing team without having to recruit and hire full-time employees. The rates for staff augmentation are lower primarily because the contracts tend to be for longer periods of time (a year or more). Some employees of professional services firms prefer the challenge of working with several new clients every year (in a project model) while others prefer the stability of being able to focus on a single client (in a staff augmentation model).

Since the bill rates of project firms are much higher and the work is sometimes more cutting edge, many services firm founders gravitate toward the project model. But those high bill rates don't always correlate to a better business. A staff augmentation firm with lower bill rates but near constant billable utilization can easily generate more gross profit over the course of the year than a similarly-sized project-based firm with higher bill rates.



## CHAPTER 1.3

# The Business of Satisfaction

Accounting firms are not in the business of preparing tax returns. Law firms are not in the business of drafting legal agreements. Web development firms are not in the business of building websites. The simple truth is that all professional services firms are in the business of delivering satisfaction.

So, what is the definition of “satisfaction” and how do you ensure it? **Satisfaction is the difference between the realized experience and the expected experience.** When the realized experience is better than the expected experience, satisfaction will be high. When the realized experience falls short of expectations, satisfaction will be low. It is a simple concept, yet it’s one that many firms fail to grasp.

Our definition of satisfaction includes what’s possibly the most important word in professional services: expectations. How you set and manage expectations heavily impacts the client’s ultimate satisfaction. For professional services firms to prosper over time, they must set clear and honest expectations with clients from the first interaction (before the sale), regularly communicate progress toward those expectations, and proactively reset expectations any time a new learning or event has impacted the project.

The certain path to extinction for a professional services company is to consistently deliver an underwhelming experience to clients. You may survive one or two unhappy clients, but with each unhappy client, the headwinds become a little stronger. Once your firm becomes known for delivering inferior client satisfaction, it is nearly impossible to turn that reputation around.

As discussed in a later section of Compass, it is important to assess the satisfaction level of each client objectively. The best way to do this is to survey clients within a couple months of the completion of each major engagement. You can’t just assume that clients are happy because you aren’t hearing many complaints. A lack of complaints is not a proxy for high satisfaction. You must explicitly ask clients to state their level of satisfaction and also solicit recommendations for improving that satisfaction.

Also, while most firm leaders know the importance of client satisfaction, what sometimes goes underappreciated is the satisfaction of employees. In order to achieve sustained prosperity, the professional services firm must also nurture and cultivate a happy workforce. When a firm has unhappy employees, voluntary attrition rises, utilization is disrupted, and it becomes increasingly difficult to recruit new personnel. Since the majority (if not all) of the revenue that your firm earns is via the expertise and hard work of your employees, it is imperative that you keep those employees happy.

Because satisfaction is so integral to the prosperity of your professional services operation, we have dedicated two entire sections of Compass to the topic.



## CHAPTER 1.4

# A Delicate Balancing Act

All varieties of professional services companies have the common challenge of balancing supply with demand. The “supply” side is your pool of capable workers (who could be employees or contractors), and the “demand” side is your set of sold projects that need to be delivered.

If balance is not maintained between supply and demand, the firm will ultimately suffer. If there are too many workers and too few projects, profitability will take a hit. When this supply surplus persists, the firm will likely have to reduce headcount. On the other extreme, if there are too many projects and too few workers, client satisfaction will take a hit. When a project surplus persists, project schedules will get delayed and clients will grow frustrated.

The never-ending task of firm leadership is to continuously balance supply and demand. In reality, the two sides are never perfectly balanced, but the goal is to keep them reasonably level. This takes daily monitoring, forecasting, and adjusting. Ignoring a significant out-of-balance condition for even a small period of time will have negative downstream effects.

In order to maintain equilibrium, firm leaders need a reliable forecast of the volume and type of upcoming project work. That forecast of future work is comprised of projects that have already been sold as well as projects that are highly likely to be sold soon. This forecast directly informs the firm’s hiring decisions, termination decisions, and general sales aggression (i.e. bill rate discounting on new opportunities).

The two tools that are used to feed the firm’s forecasting process are the revenue backlog and the sales pipeline. The revenue backlog is a ledger of all sold work that has yet to be delivered. Ideally, the sold work in the backlog will be proactively allocated to specific people within the firm. The sales pipeline captures data on all of the sales opportunities the firm is currently pursuing. The opportunities with a high probability of being won are factored into the firm’s forecast. While it is fairly simple to track sold work and who will deliver that work, it is a little trickier to predict which sales opportunities will convert into projects.

The forecast, revenue backlog, and sales pipeline are covered in more detail in later sections of Compass.

## CHAPTER 1.5

# The Key Performance Indicators of Professional Services Firms

Regardless of your professional services firm's specialty, there are some important metrics that you should track and analyze on a regular basis. Later sections of Compass will go into more detail about these metrics and many others.

## Client Satisfaction

Simply put, if client satisfaction is consistently low, your firm will eventually go out of business. To measure this metric, survey clients at least once per year and consider utilizing the Net Promoter Score approach to maximize the response rate. Leverage survey comments to develop plans for providing a better overall client experience.

## Employee Satisfaction

Professional services firms are literally nothing without their employees. You should conduct an anonymous employee survey at least once per year and encourage candid feedback. Take the time to understand employee concerns and develop a plan for improvement. Track and publish your firm's scores on an ongoing basis to measure progress in areas of dissatisfaction.

## Weighted Sales Pipeline

Not all sales pipelines are created equally. It is entirely possible that a pipeline with \$10M in gross value is better than a pipeline with \$100M in value. Why? Because the gross pipeline doesn't tell you how much actual revenue is likely to come out of it. To understand that figure, we need to analyze the weighted pipeline. The weighted pipeline considers both the projected revenue of each opportunity and the probability of the opportunity closing. A \$1M opportunity with a 5% probability of closing would contribute just \$50,000 to the weighted pipeline whereas a \$100,000 opportunity at 90% would contribute \$90,000.

## Revenue Backlog

The revenue backlog captures all sold project work that has yet to be delivered. By evaluating the total revenue backlog and weighted sales pipeline together, you can produce a reasonable forecast of the amount of work that will need to be delivered in the next few months. When both the sales pipeline and revenue backlog move significantly in the same direction (up or down), it can signal that you need to take action (such as hiring additional employees).

## Project Gross Margin

You should track several important metrics for every project that your firm delivers. The most important of these metrics is gross margin. To calculate the gross margin, you first have to determine the project's gross profit. The gross profit is simply the revenue generated minus the costs of delivering that revenue. Those costs typically include the salaries of the people on the project and any non-reimbursed expenses. To calculate the project's gross margin, you divide the gross profit by the revenue, and you express the result as a percentage. A \$100,000 project that produces \$35,000 in gross profit would yield a 35% gross margin.

It is important to calculate gross margin on a per-project basis as well as across the portfolio of projects as a whole.

## Billable Utilization

Billable utilization is the number of billable hours delivered in a given timeframe divided by the available hours in that same timeframe. If a consultant bills 30 hours in a 40-hour week, the consultant's billable utilization for that week is 75%. Billable utilization is an important metric to review regularly but should be evaluated in conjunction with other utilization metrics (as described in a later section of Compass). It is important to measure billable utilization for each employee as well as for the workforce as a whole.

## Realization Rate

The realization rate is the percentage of billable hours worked that result in actual revenue. At first glance, this can seem confusing because all billable hours create revenue. But there are times when that isn't true. If there are mistakes made on the project's deliverables or work

simply takes too long to complete, firm leadership may opt not to charge the client for some of the worked hours. If, during the course of a month, a consultant bills 140 hours but only 100 of those hours result in revenue, that yields a realization rate of 71.4%. You should strive for an overall company realization rate that's as close to 100% as possible.

## Effective Bill Rate

In addition to realization rate, it is important to evaluate the effective bill rate of projects and the variance of that rate from the original plan. The effective bill rate is the total revenue earned to date divided by the total number of hours worked (including billable and non-billable hours). While a fixed fee project could have a 100% realization rate (since all hours are considered billable), its effective bill rate could be well below the original plan.



## CHAPTER 1.6

# Interpreting Financial Statements

Financial statements are used in all industries to convey a comprehensive overview of a company's financial activity and health. They aren't unique to professional services, but there are some nuanced differences compared to other industries. Some boutique services firm leaders don't fully understand how to read financial statements and leave it up to their accountant. But this is a mistake. Every leader of a professional services firm should understand the basic mechanics of their financial statements.

The three primary financial statements you'll encounter are the Profit & Loss Statement (also called the Income Statement), the Balance Sheet, and the Statement of Cash Flows. The sections below summarize each artifact including any considerations that are unique to services firms.

### Acme Company Income Statement

<b>Services Revenue</b>	\$	<b>100,000</b>	
Cost of Services Sold	\$	65,000	
<b>Gross Profit</b>	\$	<b>35,000</b>	35.0%
Operating Expenses	\$	20,000	
<b>Operating Income</b>	\$	<b>15,000</b>	15.0%
Non-Operating Income	\$	5,000	
Non-Operating Expense	\$	-	
<b>EBITDA</b>	\$	<b>20,000</b>	20.0%
Depreciation Expense	\$	2,000	
Amortization Expense	\$	-	
Tax Expense	\$	3,000	
Interest Expense	\$	1,500	
<b>Net Income</b>	\$	<b>13,500</b>	13.5%

### Profit & Loss Statement

The Profit & Loss ("P&L") Statement (or the "Income Statement") conveys the firm's revenue, costs, and profit over a period of time. Most companies evaluate their P&L on a monthly, quarterly, and annual basis. Also, it is common to evaluate each period against the same period from the prior year (i.e. the fourth quarter this year compared to the fourth quarter last year). Below is a simplified sample P&L followed by an explanation of some key concepts.

The services revenue is obviously all revenue earned during the reporting period. But what about the cost of services sold and gross profit? Many boutique professional services firms do not accurately capture the costs of services sold and thus do not know their gross profit (\$35,000 in our sample above) nor their gross margin (35%). The cost of services sold should include all costs incurred that are directly related to delivering services to customers. The vast majority of this expense will come from the salaries and overhead costs of your delivery personnel (both employees and contractors).

The reason you want an accurate gross profit and gross margin is because these speak to the profit potential of the business. Gross profit shows you how profitable your company could be if it didn't have operating expenses, such as sales and marketing costs. It essentially represents the maximum profit potential of the company during the reporting period.

Operating expenses include all costs related to general operation, administration, marketing, sales, and research and development. (Often, there are no R&D expenses in pure services firms.) By subtracting the total operating expenses from the gross profit, we get the operating income (and operating margin) of the firm. The operating income is the firm's profit before considering expenses such as income tax or depreciation. Most of the time with services firms, EBITDA (earnings before interest, taxes, depreciation, and amortization) will equal the operating income. This is because it is rare for firms to have non-operating income or expenses (i.e. selling an asset such as a computer would generate non-operating income).

## Balance Sheet

Whereas the P&L shows financial performance over a period of time, the balance sheet shows the company's assets, liabilities, and equity at a specific moment in time.

The reason firm leaders should be comfortable with the balance sheet is that it indicates the future viability of the firm. By evaluating the balance sheet, you can get an understanding of the capital structure of the company. For example, the balance sheet will indicate the company's cash on hand and any long-term debt. It will also show the types of stock that have been issued.

There are a number of important financial ratios that are calculated from the balance sheet. For example, the debt-to-equity (D/E) ratio is calculated by dividing the firm's total liabilities by its shareholder equity. The D/E articulates the degree to which the company is financing its operations via debt. Another useful ratio is the current ratio, which shows the firm's near-term

liquidity. The current ratio is calculated by dividing the firm's current assets by its current liabilities. It shows the company's ability to pay the liabilities that are due within the next 12 months. The higher the current ratio, the stronger the company's ability to pay off its near-term obligations. A current ratio that's less than 1 likely represents pending financial trouble.

## Statement of Cash Flows

While the income statement and balance sheet tend to get most of the attention, it is also important to analyze the statement of cash flows. The statement of cash flows does exactly what it sounds like – it summarizes the cash (and cash equivalents) that move in and out of the company. The cash flow statement shows how efficiently the company generates cash to pay its debt obligations and fund its operating expenses.

**The statement of cash flows is broken down into the following three sections:**

- **Cash flow from operations:** This section shows how much cash is generated by delivering services to clients. Financial activity related to cash, accounts receivable, and accounts payable will impact this calculation.
- **Cash flow from investing:** This section primarily captures transactions related to asset or security purchases. It generally shows cash leaving the business to buy new equipment, buildings, or short-term assets such as marketable securities. However, when a company sells an asset, this section would show the sale proceeds entering the business.
- **Cash flow from financing:** This section captures financing activities such as selling stock or issuing debt (i.e. taking out a loan). Any interest or dividends paid will also be reflected in this section.

Through analysis of the statement of cash flows, you can get a clear picture of how much cash the firm generates and accurately assess the financial prosperity of the company.

## Summary

It simply isn't acceptable for firm leaders to lack familiarity with the three core financial statements. Once you have mastered these reports and their associated ratios and metrics, you'll be more capable of making better strategic decisions related to growth, hiring, investments, asset allocation, and the like.



## CHAPTER 2

# Sales

## CHAPTER 2.1

# Start in a Niche

When starting a professional services firm, it is smart to tailor the firm's service offering to a niche. That niche is represented by a highly-targeted profile of an ideal pool of clients and their specific needs. A common mistake that founders make is attempting to do too many things for too many types of clients. This usually happens because founders are hungry for any type of revenue that can sustain the firm. But that short-term revenue grab results in long-term disarray. Over time, firms that are spread too thin will always underperform.

## Why Focus?

**There are several reasons why focusing on a niche is important for new professional services firms:**

- **Clients hire experts.** Prospective clients' expectations aren't complicated – they're looking for a high-quality and timely service at a fair price. Clients rightfully assume that the quality of the service will be higher if the firm is laser-focused in their specific area of need. For example, if a company needs a law firm to assist with its business agreements, it's more likely to hire a contract attorney than one who handles contracts in addition to divorce settlements and personal injury cases. Expertise is closely associated with specialization. As a specialist, you will have a higher "win rate" on target opportunities than a generalist.
- **Messaging is clearer.** It is important that prospective clients quickly understand what your professional services firm does. Many companies use Google to find and evaluate potential firms to handle their needs. Since buyers can find dozens of firms to evaluate within a few minutes, they are quick to dismiss firms that don't seem like a good fit. If someone can't clearly understand what your firm does after five seconds of glancing at your website homepage, you'll likely lose that person to the dreaded "back button click". By focusing your messaging, prospects can quickly understand what you do and whether you are a fit for their needs.

- **A reputation of quality.** The quality of the services and deliverables that a firm produces will be higher when the firm is focused. Focus brings precision and excellence. When a firm focuses its service offering, it builds a reputation for high-quality work and that reputation permeates the market over time. Referrals from existing clients will be more common, and the firm will also see more “inbound” leads than its rivals.
- **Utilization is better.** When firms have multiple service lines, there are usually employees within the firm who focus only on a specific service. This means the supply and demand for services has to be managed across multiple utilization “silos”. One practice might be running at 100% billable utilization while another is struggling. Employees in one practice might have zero applicability to the delivery of services in another practice and thus drag down overall utilization. When firms focus on a single niche, managing utilization to a desired level is much easier.
- **Operations are streamlined.** When the service offering of the firm varies, the operations of the firm must also vary. The firm’s delivery methodology and deliverable artifacts will likely be different per each service line. Also, the promotional materials, sales proposals, presentation templates, white papers, webinars, and the like will have different content. All operational aspects of the firm, from recruiting to service delivery, must vary in order to support the distinct service offerings. Variability creates unnecessary complexity.
- **Stress is lower.** When a firm focuses, it performs more predictably. When it performs predictably, there’s less stress on the entire company (especially the leaders). Lower stress creates a better environment in which to spend your time.

## Characteristics of a Good Niche

A good niche is one that will support the planned mid-term growth objectives of the firm’s leaders. Since those objectives are personal and vary greatly from one company to the next, a perfect niche for one firm might be a terrible one for another. Founders must evaluate how the niche will support their growth objectives over the next 3-5 years.

A good rule of thumb is that you want a niche that is small but growing. When a niche is small, it usually means that there aren’t a lot of competitors in the space yet. The lack of

competitors will give your firm time to establish itself as the leader. You may even be able to define the industry terms that will become ubiquitous over time.

But, if a niche stays small for too long, it might not be big enough to support your growth aspirations. That is why the growth rate of your niche is critical. When a small niche is growing, the leading providers in that niche generally ride the wave of market growth. Those established firms in the burgeoning space become the providers of choice. As new competitors enter the space, your firm will enjoy the leadership position, which was achieved by being a first mover.

## Finding a Niche

There are several ways you can narrow down your choices and select a good niche. Generally, your niche will be created by focusing on a very specific target customer profile. For example, instead of providing generic “accounting services” to consumers at large, maybe you provide tax advisory services to high net worth professional athletes who earn money in dozens of states during the year. By learning the tax laws of each state and the legal terms of professional sports contracts and collective bargaining agreements, you become the “go to” tax expert in that niche market.

**When looking to create a niche, there are some key considerations. Note that you can develop a niche by combining several of the tactics below:**

- **Vertical industry.** Possibly tailor your service offering to a specific industry (or industry sector). For example, your management consulting firm might focus on helping brick-and-mortar retailers compete in an increasingly Amazon-dominated world.
- **Horizontal domain expertise.** Consider providing services focused on a specific function that exists across multiple industries. For example, you could provide human resource legal advisory services to help clients develop employee handbooks and employment contracts that are in compliance with all state and federal regulations.
- **Client size.** Focus the service offering on a specific size of customer. This could range from Fortune 500 companies to tiny startups. It is very hard to serve all sizes of clients because their needs vary widely with the headcount.
- **Service type.** Rather than provide all of the typical services that are common with your firm type, you could focus on one service where your firm can truly shine. For

example, instead of launching a generic marketing agency, narrow that down to a branding agency that exclusively focuses on corporate identity development for large consumer-focused companies.

- **Product expertise.** Focus your services around a specific third-party product. If you are an IT services provider, instead of being a generalist, maybe you focus on implementing a specific high-growth product such as Twilio or Workday.

## A Niche can Expand

As your firm matures, it may make sense to expand beyond the original niche. Again, this largely depends on the growth aspirations of the firm's leaders (and Board of Directors). If it becomes clear that the niche market won't satisfy your growth goals, expanding from the initial niche could be required. You should only do this once the firm has the people and processes in place to yield consistent business performance. Prematurely expanding the firm's focus can create chaos and disastrous financial results.



## CHAPTER 2.2

# Marketing for Professional Services Firms

Marketing tactics tend to vary by industry and by the size of the company. A large consumer goods company, like Pepsi, might leverage a Super Bowl commercial to drive demand and brand awareness. A small management consulting firm that thrives on “word of mouth” referrals might engage in little to no marketing beyond its company website.

Most professional services firms can’t afford Super Bowl ads or hundreds of billboards in cities throughout the United States. But even if they could, those marketing tactics likely wouldn’t generate the best return anyway. Why? Because professional services firms are selling domain expertise (knowledge) instead of static products. It is difficult to articulate domain expertise in a 30-second TV commercial or in a momentary glance at a billboard.

When a client hires a professional services firm, the client wants high-quality deliverables produced within a reasonable period of time and at a fair price. It’s really that simple. The job of the marketing team is to convince prospects that the firm can satisfy these goals. When it comes to developing a marketing plan for a professional services firm, the focus should be on channels that best enable the firm to articulate its value proposition.

**A marketing message for a professional services firm should generally convey the following:**

- We are experts in our area of focus.
- We consistently deliver high-quality work.
- We are trusted by industry-leading clients (list them if possible).
- We are fairly priced. (Note: this is not the same as “low-priced”.)

**The following are the marketing tactics that tend to generate solid lead flow for professional services firms:**

## Website

To a degree, this goes without saying, but if you want to position your firm as an industry leader, you need an industry-leading website. The website needs to be professional and polished. The content (i.e. case studies, white papers, press releases, etc.) needs to be engaging and regularly updated.

When clients are evaluating potential services firms, they often form their initial impression based entirely on the website. First impressions are usually lasting impressions, so you want to make a good one. It is important to invest appropriately in both user experience and content. This may require engaging an outside design agency and will likely require significant internal (non-billable) time in order to create valuable content.

**From a marketing perspective, a professional services firm website should include some or all of the following:**

- A list of clients and testimonials
- A clear description of the services offered
- Case studies of past engagements
- White papers on topics of interest to clients
- Webinars (both live and on-demand) on topics of interest to clients
- Press releases showing the activity and momentum of the firm
- Blog posts on relevant topics
- A list of events and conferences that firm experts will be attending
- A list of important awards that the firm has won
- Bios of the firm leaders (including high-quality photos)
- A description of the firm's delivery processes (i.e. methodology)

## Content Marketing

Closely associated with the firm website is the firm's content marketing strategy. Content marketing is about providing useful content that can attract, acquire, and engage a target audience (your ideal clients).

There are two broad benefits of a content marketing strategy for a professional services firm. First, the content itself will help differentiate your firm as a domain expert and thought leader in your area of focus. Second, the content will be indexed by search engines and drive traffic to your website at no cost. Highly-targeted, free internet traffic is very tough to come by but a strong content marketing program can deliver it.

The main objective of content marketing is to educate an audience. You want to create content that will substantiate your firm as a thought leader with deep domain expertise in a given subject. **The following examples are excellent content marketing techniques for educating an audience:**

- An eBook or articles that link back to your website
- Regular blog postings
- White papers
- Webinars
- Case studies
- Videos (possibly hosted on YouTube)

## Speaking Engagements (including podcasts)

Another good way to convey your firm's domain expertise is to have firm experts participate in speaking engagements. These engagements can vary from industry conferences to podcasts to local meetups. It is particularly useful to engage in speaking events where customers are likely to be in attendance.

Speaking engagements can be a great way to enhance your firm's relationship with its existing clients while at the same time acquiring new clients. If there are specific topics that are in high demand in your industry, hosting a free "lunch and learn" in your city can be a great way

to educate clients and prospects to reinforce your domain expert status. Aside from establishing your dominance in a particular subject area, you get the added benefit of connecting existing clients with prospects. This is important because there is no better way to convince a new prospect to hire your firm than to have your existing customers rave about how great you are to work with.

## Networking

The business of professional services is largely about relationships – relationships with employees, clients, prospects, and partners. Networking is one of the oldest means of creating and developing these professional relationships.

As it pertains to lead generation, networking generally does not provide a quick return on the time invested. Don't expect to go to an event tomorrow and win a new deal next week. But when done well and consistently over many months or years, networking has a compounding positive impact on sales.

It is important for representatives across your firm to get out in the community and network. It is particularly useful for salespeople, delivery experts, and even recruiting personnel to be regularly active. Each of these groups can have a positive impact on the impression of your firm's brand in the market and that will eventually correlate to sales and key hires.

One important networking tip is to focus on helping others. The best way to get new business opportunities from people in your network in the future is to help those people accomplish something today. Make an introduction, provide some free counsel, help establish a partnership, etc. In short, the best way to receive in the future is to give today.

*"37% of consultants identified referrals as their primary channel for new business opportunities."*

*ConsultingSuccess.com*

## Paid Search Marketing

Paid search marketing (e.g., Google AdWords) can make sense for professional services firms that focus on a specific niche of a market (such as a vertical or horizontal segment

within a few geographies). With the proper approach to paid search marketing, you can drive highly-targeted traffic to your website. If you spend \$3,000 per month on paid search but generate a \$100,000 client once per quarter, that is a \$3,000 monthly check you'd be very happy writing – especially when you factor in the repeat business and referrals the new client may engage in over the years.

One caution with paid search marketing is that if you don't know how to configure your campaigns properly, the costs can spiral out of control and/or the quality of the traffic can be low. If you do not have expertise with paid search marketing, you are far better off paying a specialist a few thousand dollars to set it up and manage it for you.

## Industry Trade Shows and Conferences

While trade shows and conferences don't always generate high-quality leads, they do give you an opportunity to network with clients and prospects. In general, you want to invest in the conferences that your current clients attend. Conferences will often have social events in the evenings that are ideal for forming relationships and partnerships. A big part of professional services is building and nurturing relationships, and conferences provide a good means of doing that.

## Email Marketing and Newsletters

It is important to capture email addresses from clients, prospects, partners, and others in your industry. You can acquire email addresses from numerous avenues including event registrations, webinar downloads, newsletter signups, existing clients, etc. Your firm should be growing its email database consistently month after month. The goal should be to eventually collect thousands of email addresses and communicate with those recipients on a regular basis.

One reason email addresses are so important is that email is often the best way to alert people to new useful content on your website. Also, if your company is hosting a local event or webinar, an email blast is the best way to promote the event to potential attendees.

## Referrals and Word of Mouth

The best form of marketing is when your existing clients rave about your firm to their peers in other companies. You can't put a price tag on it. These types of referrals often produce project opportunities that aren't competitive (meaning, you aren't competing against other firms for the business.)

In a survey of over 34,000 consultants in 2019, Consulting Success found that 37% of consultants identified referrals as their primary channel for new business opportunities. The best way to get these referrals is by creating incredible value for your existing clients. You should strive to exceed expectations with existing clients 100% of the time.

## CHAPTER 2.3

# The Sales Pipeline

The sales pipeline is a ledger of all of the prospective sales opportunities of the firm. The combination of the sales pipeline and revenue backlog allows the firm to forecast the future demand for its services. That forecast enables a reasonable prediction of near-term billable utilization, billable hours, and revenue. The forecast is instrumental in proactively managing the delicate balance between supply and demand in a professional services firm. Thus, the pipeline is crucially important since the revenue forecast is predicated upon it.

So, what are the components of a sales pipeline? With modern Customer Relationship Management (CRM) systems, companies can capture virtually any information related to their sales opportunities. But there are common data elements that every professional services firm should capture. **These are summarized below:**

- **Opportunity Name** – A short description of the opportunity.
- **Prospect Name** – The name of the client.
- **Opportunity Summary** – A brief overview of the potential project and client needs.
- **Stage** – Many companies associate a stage with the probability of the deal closing. For example, a stage of “Qualifying Opportunity” might have a 5% probability to close while a stage of “Negotiating Contract” might have a 90% probability to close.
- **Probability** – The likelihood that the opportunity will be won, expressed as a percentage. As mentioned above, some firms set this automatically based on the opportunity stage. This is usually done to create a more objective pipeline. But basing the probability solely on stage can also reduce accuracy.
- **Size (\$)** – The dollar amount of the opportunity.
- **Estimated Hours** – A rough estimate of the number of hours that it will take to deliver the project.
- **Source** – The origination of the opportunity. Tracking the lead source can help identify the most effective marketing tactics or lead generation personnel.

- **Type** – The type of project. If a firm delivers several types of projects that require different skills, it is important to identify the project type for resource forecasting purposes.
- **Expected Close Date** – When the deal is expected to be closed/won.
- **Expected Start Date** – When the project is expected to start. Sometimes this will be immediately upon contract signature, but usually it will be some number of weeks later.
- **Duration** – The number of weeks that the project is expected to take. The duration helps the resource planners understand how the volume of hours will be delivered. Will the project require 10 people for four weeks or four people for 10 weeks?

While you can track many additional fields, the ones above are the most important.

## The Gross and Weighted Pipeline

No two pipelines are created equally. Pipelines with the same total revenue potential can ultimately yield wildly different dollar amounts. This happens because there can be a significant difference between the dollar value of the “gross pipeline” and that of the “weighted pipeline”.

The gross pipeline is simply the sum of the deal size associated with each opportunity in the pipeline. If there are 10 opportunities in the pipeline that each have a \$20,000 deal value, then the gross pipeline is \$200,000. But the gross pipeline figure isn’t very helpful in determining how much billable work is likely to be generated. To understand that, we need to look at the weighted pipeline.

The weighted pipeline factors in each opportunity’s probability to close. For example, if a \$100,000 opportunity has a 5% probability to close, that opportunity only counts \$5,000 to the weighted pipeline. The weighted pipeline gives you a much better indication of the likely revenue that will be generated. A \$10M gross pipeline with high quality opportunities could easily produce more revenue than a \$50M gross pipeline full of unlikely deals.



## Pipeline Management

One of the more important functions in a sales organization is pipeline management. A senior leader in the firm should be responsible for continually validating the accuracy of the data in the pipeline. This requires daily attention in order to maintain a valid pipeline and revenue forecast. At a minimum, sales personnel should update their pipeline opportunities on a weekly basis to adjust key fields or to provide commentary on recent activity. When a pipeline becomes stale, it grows increasingly inaccurate and eventually becomes harmful to the management of the firm.

In addition to keeping opportunities up to date, it is important to focus the firm's energy on closing the high-probability opportunities. While there may not be a lot that the firm can do to accelerate a 10% probable deal, there are ways to get a 90% probable deal over the finish line. The sales and delivery leaders of the firm should meet weekly to review each high-probability opportunity. The goal of this meeting is to ensure that every effort is being made to win these deals. Possibly, there are incentives that could be extended or your CEO could call the sponsor to express your firm's commitment to the client. The key is to apply maximum senior-level energy to the deals that have the potential to close soon.

## CHAPTER 2.4

# Basic Best Practices

Selling a professional service is generally more difficult than selling a product. Why? Products are tangible and services are not. Products have a fixed set of characteristics and configurations while services are usually dynamic and customized. Selling something intangible that will be customized is much harder than selling something tangible that is fixed.

If you sell cars, you need to learn about each model in the showroom, memorize the important features, know the competitive products from other manufacturers, and so forth. There is a finite amount of information to master, the product options are fixed, and customers can test drive the exact car they are considering. With services, the required knowledge is often vast, the work is usually customized to client needs, and clients can't physically interact with the service before making a buying decision. This dynamic results in greater risk for buyers, increased scrutiny on sellers, and a complex sales process.

While selling professional services is difficult, there are some simple best practices that will help drive success.

## Listen

Far too often, when meeting with a new prospect, firm personnel spend too much time talking and not enough time listening. Clients don't want to spend an hour hearing about your firm's accolades and delivery methodology – they want to hear how you will satisfy their unique needs. If you don't listen carefully to their needs first, you won't be able to engage in meaningful conversation about a solution.

The first half of your initial client meeting (or call) should be focused on learning about your prospect's needs. Simply listen and ask questions in order to learn as much as possible. Once you have a general understanding, the second half of the meeting should be focused on how your firm would likely address those needs. If you have engaged in similar projects in the past, you can discuss how the needs of those clients were satisfied.

## Research

Before any significant sales meeting (or call), put in the time to understand the client's business, industry, and competitors. To put it bluntly, do your homework. If the client's team has provided an overview of the business need (or possibly an RFP), read it carefully before any sales call. Try to understand the specifics of the pain, its origination, remedies attempted thus far, and the ultimate goals and objectives.

With a few Google searches, you can quickly educate yourself on the background of the company, industry, and key individuals. Coming into an initial sales meeting armed with that knowledge will always impress decision makers. **Some of the things you can learn during just an hour of prep time include:**

- The history of the company
- The products and services
- Background of the executives
- Recent press and activity (such as mergers or acquisitions)
- Backgrounds of all personnel you will meet with (use LinkedIn)
- Competitors and their differentiators
- Industry news and trends
- The company's financial performance (available for publicly traded companies)

When prospects hear you speak intelligently about the topics above in the very first meeting, you are much more likely to make their shortlist. They will realize that you understand their business and that you do your homework.

## Ask Questions

As you research the prospect's business and industry, be sure to jot down specific questions that you can ask during the next call or meeting. Asking smart questions accomplishes two objectives at once for you. First, it helps you better understand the prospect's specific needs and high-level objectives. Second, it shows the prospect that you are thinking through their

business needs carefully. When prospects see a high level of effort and diligence during the sales process, they feel confident that your firm will sustain that level throughout the engagement.

## Get Your Experts Involved Early

With professional services selling, you must convince prospects that your firm is a credible and high-quality provider. If you aren't able to do this early in the sales process, you may not make the shortlist. For firms that have traditional salespeople (who are not "partners" or service delivery personnel), you want to ensure that delivery experts are also introduced to the prospective client early in the process. While salespeople are great at finding opportunities and articulating the high-level value proposition of the firm, prospects rarely make a buying decision based on the salesperson alone. They need to engage with the people who will actually be doing the work. Put your best delivery experts in front of your most important prospective clients.

## Demonstrate

If a picture is worth a thousand words, a demo is worth a thousand pictures. If your particular professional service can be demonstrated reliably, it should be. Some pundits caution against "live demos" because demos can be prone to technical problems, unforeseen bugs, connectivity issues, etc. But, if you build a high-quality demo, it won't fail and the connectivity logistics can be easily addressed (i.e. bring a Wi-Fi hotspot). A live demo will do more to win business than anything you put in a proposal or PowerPoint presentation.

## Show Sample Deliverables

If your firm produces high-quality deliverables over the course of an engagement, showing samples of those deliverables to prospects can help win new business. Every vendor that is pitching a prospect will show colorful slides of their delivery process (methodology) and will list the deliverables that will be produced. But most of those vendors won't bring a complete set of sample deliverables to the sales meeting. Allowing prospects to flip through actual past deliverables will go a long way in building credibility during the sales pursuit.

Note that since any such deliverables will likely be from an actual past engagement, you will need to change the client name, project name, and any other identifying information.

## Produce High-Quality Sales Materials

Your presentation and proposal materials should be of the highest quality. These materials show the client how seriously you take your work. If the presentation has slide numbers that are out of order or your proposal lists a different client's name in the page footer, it looks sloppy. Sloppy rarely wins.

If you don't have creative expertise within your firm, this is one area where you should contract with an outside consultant or freelancer. Even if your firm is small, it should have a presentation template and proposal template that rival that of the best firms in your industry. The colors, branding, design treatment, style, fonts, table format, graphics, and other attributes should be coordinated and visually compelling.

In addition to the "look and feel" of your presentation and proposal, the content should likewise be impressive. You don't want "fluff" in these materials; you do want substantive content that speaks directly to the prospect's area of need.

## Be Honest

Being honest with prospects is important for both the initial sale and the long-term health of the relationship. To become a trusted advisor, the client sponsor must realize that you consistently prioritize the client's best interest. You start building that trust with the first sales touchpoint. If you aren't the best provider to handle a project, be honest and recommend other firms that could be a better fit. If specific portions of the project would be better off delivered by another firm, make that clear. You'll earn deep goodwill that will manifest in future business and referrals.

## Be Personable

Professional services is a people industry. Clients aren't just hiring a firm – they are hiring a specific team of people within that firm. The decision to work with your company is heavily based on how comfortable the client is with each individual involved in the sales process. Be engaging, be kind, be helpful, be informative, be funny, and be honest. Simply put, be personable.

## Set and Meet Expectations

The sales process is essentially a “taste test” of what it will be like to work with your firm over a large engagement. Throughout the sales process, your firm should be setting and meeting expectations with the prospect. **Some simple ways to do this well include:**

- Sending meeting requests several days prior to meetings (or calls).
- Providing all meeting materials at least 24 hours before each meeting.
- Having a clear agenda (with objectives) for meetings and keeping meetings on track.
- Taking diligent and detailed notes during meetings.
- Committing to getting an answer and circling back as soon as possible if you can’t answer a question during a meeting.
- Stating any action items for meeting participants at the end of the meeting, including action items on the client side.
- Providing notes to all meeting participants within 24 hours of the meeting.
- Communicating clearly, consistently, and efficiently.
- Walking client personnel through your proposal over the phone or in person.
- Regularly asking the client if you can be of additional assistance in any way.

Many of the tasks above are essentially basic project management duties. If your salespeople aren’t capable of consistently handling these duties, you should attach a project manager to sales pursuits to run the logistics. A good project manager can spend 30 minutes per day ensuring that the basic tasks listed above are being handled.

## Care About the Little Things

Oftentimes it is the little things that you do for other human beings that have the biggest impact. To do the little things well, you simply need to care, be present in conversations, and be well-organized. Send a birthday card to the client sponsor each year (put a reminder on your calendar), ask how the big internal presentation went, or send a congratulatory card for his or her child’s graduation. The little things often end up not being little at all.

## CHAPTER 2.5

# Provide Clients with Options

When pursuing a new business opportunity with a prospect or existing client, it is a good idea to provide a few different options within your proposal. You should think of these as “good”, “better”, and “best” options with corresponding scopes and price ranges. While you might have a strong inclination as to the most appropriate route for the client, it never hurts to provide options.

A good way to think about the proposal process is to imagine yourself as a fisherman. If you had to catch fish in order to feed your family, would you use a single fishing rod and one type of bait? Or, would you use multiple rods, each with a different type of bait? Professional offshore fishermen use a technique called trolling, in which they have dozens of hooks on outriggers using different types of bait and lures. The idea is to increase the odds of success by presenting options to the fish. In professional services, you don’t want to present dozens of options to prospects, but it is a good idea to offer a few.

## Champagne Taste on a Beer Budget

One reason to offer options in your proposal is that a prospect can appear to have a large budget during the sales process but base the final vendor selection on a much smaller budget. **This can happen for several reasons, such as:**

- **The prospect may want to understand what the “Cadillac” option looks like.** They may ask a lot of questions about higher-end services that they likely can’t afford. They are getting a free education from you in the presentation and proposal.
- **Your contact within the prospect might not know what the actual budget is.** How often have you heard the words, “We haven’t finalized our budget yet”? If the prospect hasn’t defined their budget, how can you provide a “one size fits all” scope and price?

- **Budgets get cut at the last minute.** It is not uncommon for a prospect to get cold feet on a large spend when it is time to make a decision. A lot can change between the time you present your proposal and when ink hits the contract.
- **Executives weigh in last.** Your project sponsor may not be the final decision maker. You should assume that there will be one or two executives involved in the decision chain whom you have never met. Those executives may have an entirely different vision of the project scope and cost than your sponsor.

## Low Pricing Can Also Lose

One of the most frustrating events in professional services selling is losing a deal because “your vision wasn’t big enough”. This usually means that some other firm won the business by proposing a larger and more robust set of services and deliverables at a higher price. The prospect may have liked you the best, but just felt that you didn’t grasp the entirety of their needs.

Just as you may misread a prospect’s budget on the high side, you can also lose deals by shooting too low. Again, this can be caused by a final decision maker who has a different set of priorities than your direct contact. If you pitch a Honda while the executive involved wants a Cadillac, you lose the deal.

So, the best approach is to cover your bases. Propose “good”, “better”, and “best” options and do so in a way that doesn’t make the “good” option feel cheap or the “best” option feel gold-plated.



## CHAPTER 2.6

# All Revenue is Not Created Equally

One of the biggest mistakes a professional services firm can make is to blindly chase revenue. When a firm chases revenue, it focuses too much on the sale and not enough on the final project outcome. High-dollar deals all feel great when the ink is still fresh on the contract. But deals that aren't set up for success from the outset can wreak havoc on the firm down the road.

**So, what is a “good outcome” for a professional services engagement? It should check the following boxes:**

- **The client is pleased.** The best way to gauge client satisfaction is to survey the client a few months after the engagement is completed. Generally speaking, clients are happy when their expectations have been met. Clients have expectations in terms of the quality of the services and deliverables, the time the project will take, the cost, and the experience of working with your team. You should strive to meet or exceed expectations in each of these areas on every project.
- **The team is happy.** Did the project team have to work 12-hour days and weekends in order to hit an unrealistic deadline or was the engagement well-planned? When a firm has a culture of making unrealistic demands of its employees, attrition will rise and performance will fall. Employee satisfaction eventually impacts client satisfaction.
- **The target profitability is achieved.** It is possible to have a pleased client and happy team, while at the same time producing a terrible economic result for the firm. Each and every project should be diligently estimated in order to determine a target profit margin for the work. If the project can't be delivered at an acceptable margin (i.e. due to an insufficient client budget), you are better off passing on the work.

## Ways that Firms Chase Revenue

There are a lot of ways that a professional services firm can make the mistake of winning bad projects. **Below are some of the more common ones:**

- **Pay sales commissions on topline revenue.** If salespeople are compensated on the topline revenue of each deal, they won't worry about whether or not the engagement is set up for success. Dropping a \$200K deal down to \$150K won't hurt the sales representative much but it could kill the project's financials. Salespeople should be compensated on the gross profit of the proposed project, not on revenue.
- **Drop bill rates too low.** When bill rates are arbitrarily reduced without evaluating the revised budget and projected profit, bad things tend to happen. While some amount of bill rate discounting can make sense to win a large deal, the discount shouldn't coincide with significant project risk factors.
- **Propose a fixed fee billing structure with uncertain scope.** Clients often prefer a fixed fee quote, because it eliminates their budget risk. However, the only time this makes sense for the firm is when the scope of work is very well-understood and subsequently detailed in the legal contract. Often, the worst outcomes are a result of a fixed fee project going hopelessly over budget.
- **Fail to properly estimate or budget.** It is imperative that professional services firms have a rigorous estimation and budgeting process. The process should be detailed enough to produce a reliable target profit margin. If the estimation and budgeting process fails to yield an acceptable profit margin (due to client budgetary constraints), pass on the work.
- **Wander outside of the firm's wheelhouse.** Sometimes a firm will pursue a type of engagement that it hasn't delivered before. This often happens because the size (revenue) of the project is attractive or because the firm has excessive bench. The problem with project types that you haven't delivered before is that you don't know much about the challenges you'll encounter. It is hard for a firm to deliver quality work on-time and on-budget with its first attempt at a project type.

## CHAPTER 2.7

# Forecasting

A forecast is a prediction of the future. A weather forecast attempts to predict if you'll need an umbrella later this week. A professional services forecast attempts to predict the amount of work (and corresponding revenue) the firm will deliver in a future period. The forecast may also predict the specific skills required by the work and the number of hours needed per skill.

**The forecast is arguably the most important artifact for firm management to evaluate and scrutinize on a regular basis.** This is because the forecast indicates the future supply/demand balance of the firm. Keeping supply and demand reasonably well-balanced is one of the primary responsibilities of firm leaders.

One of the best ways to improve the performance of a services firm is to extend the visibility of the future demand on services. If Consultancy A can only predict its future work for the next 4 weeks and Consultancy B can predict its work for 12 weeks, it is almost certain that Consultancy B is a better business. The further out you can reliably predict the demand for your services, the easier it is to run the business.

In order to maximize the visibility of services demand, the firm needs an accurate forecast. That forecast is comprised of two underlying components – the revenue backlog and the sales pipeline. The revenue backlog is a ledger of all sold work that has yet to be delivered and the sales pipeline is a ledger of all potential work that has yet to be sold. Most forecasts add the backlog for a period of time (i.e. the next quarter) with a portion of the pipeline for that same period.

Since the backlog is comprised of work that has already been sold, it is fairly easy to predict which portion of the backlog will be delivered in a future period of time. If the firm has a good resource optimization and planning function, it can allocate work to individuals and predict future hours and revenue with reasonable accuracy. But the sales pipeline component of the backlog is not as predictable. This is because the deals aren't closed and key data points (such as probability) tend to change on a daily basis.

Most firms factor only a portion of the sales pipeline into the forecast. For example, a firm may decide to include only the weighted revenue from deals that are >60% likely to close. So, a \$100,000 opportunity at 50% wouldn't count at all in that forecast while a \$200,000 opportunity at 60% would add \$120,000 toward the forecast (60% of \$200,000 = \$120,000). This type of approach illuminates how important it is for opportunities in the pipeline to have accurate deal values, probabilities, start dates, and durations.

When a services firm has predictability of future demand, it can proactively adjust its workforce capacity to meet that demand. For example, if a firm with 50 delivery personnel has a goal to deliver 140 billable hours per person per month, that totals 7,000 hours per month across the company. If the firm's forecast for the next three months calls for 7,000 hours, 9,000 hours, and 10,000 hours, that indicates that the firm will have difficulty delivering roughly 5,000 forecasted hours over those final two months. The only way to deliver those hours will be to hire or require significant overtime from the existing team. Recognizing this future resource crunch, firm management can advise the recruiting team to maximize its efforts to add new delivery personnel.

## CHAPTER 2.8

# Bookings vs. Billings vs. Revenue

With small-to-midsize professional services firms, there tends to be confusion related to the topics of bookings (or sales), billings, and revenue. It is important for firm leadership to understand these separate (but related) concepts as there are implications to the company financials, income tax obligations, and sales compensation plans.

To best explain the differences between these concepts, we will use a sample client engagement. Let's suppose your mobile app consultancy has been hired by Acme Company to build a customer loyalty application. The contract is for \$100,000 with \$50,000 due at signing and \$50,000 due at the completion of the project.

## Bookings

Bookings are simply the total amount of sales in a period of time (typically a month). So, in our example, the entire \$100,000 related to the Acme Company mobile app would hit your bookings for the month in which the contract was signed. Even if you haven't cut an invoice yet or started working on the project, you would capture the entire \$100,000 in bookings immediately upon contract execution. Note that bookings are not revenue and do not show up in your accounting platform or on your income statement.

## Billings

Billings correlate to your total invoices for a period of time. Since \$50,000 was due from Acme Company upon contract signature, that \$50,000 would contribute to your total billings for the month in which the invoice was created. Again, the \$50,000 would count toward billings even though none of the services have been delivered. The \$50,000 would be reflected in the accounting system in the form of an invoice but shouldn't be reflected as revenue just yet.

## Deferred Revenue

Any time your firm collects revenue that it hasn't earned, that revenue should be reflected on the balance sheet in a liability account called "Deferred Revenue" (or alternatively, "Unearned Revenue"). In the case of your initial \$50,000 invoice to Acme, none of that was earned when the invoice was created because you hadn't started working yet. Thus, the entire \$50,000 should sit on the balance sheet in Deferred Revenue, waiting to be moved to the income statement as the project is delivered.

## Revenue

Revenue is the actual dollar amount that can be recognized in a month given the percentage of the project that was completed during the month. While the concepts of bookings and billings are simple, revenue and when you can recognize it can get a little more involved.

If during the first month of the project you complete just 10% of the project work, you can recognize \$10,000 in revenue during the month. Your accountant would move \$10,000 out of the Deferred Revenue balance sheet account into your services revenue account on the income statement. If in the second month the total percentage complete reaches 30%, an additional \$20,000 would be moved to the income statement.

Since your final \$50,000 in billings won't exist until after you complete the entire project for Acme Company, what happens after the first \$50,000 has been fully recognized on the income statement? You can actually run a negative balance in the Deferred Revenue liability account and recognize revenue on the income statement that you haven't even invoiced for yet. Yes, that is a bit confusing! But following proper revenue recognition processes makes it much easier to manage the company and compare one month to another. Running a consultancy without proper revenue recognition procedures causes a highly-variable revenue line and wild swings in profitability from month-to-month.

Note that time and materials (hourly billing) engagements rarely require revenue recognition procedures. With time and materials projects, you are invoicing for the work that was completed in the given month. Thus, you are rarely invoicing more or less than what was earned and do not need to use the Deferred Revenue balance sheet account.

## CHAPTER 2.9

# Estimation

A detailed estimation process is important for professional services firms that deliver highly-customized services and deliverables. With customization comes variability in effort (and cost), and that variability correlates with engagement risk. That risk can be mitigated with a rigorous estimation process. Without a reliable estimation process, there is an increased risk of poor client satisfaction and reduced project profitability.

## Estimation Basics

What is estimation for a professional services firm? An estimate is a prediction of a future project's delivery. It isn't simply about coming up with a price for the project; it is about modeling each key aspect of the project. **Specifically, a good estimation process will yield the following:**

- The set of tasks that will need to be completed in order to deliver the project.
- The project roles (including skills and experience level) that will be required to complete each task.
- The estimated hours needed to complete each task.
- The materials or other expenses (such as travel) that will be required over the course of the project.
- The estimated total fees to deliver all of the tasks (usually determined by applying bill rates to the project roles and hours).
- The organization of all associated tasks into a rough project plan with dependencies, in order to predict the amount of calendar time needed to complete the project.

A good estimate brings clarity to the tasks, roles, hours, expenses, fees, and the timeline of a potential project. Your client's primary questions may seem simple. "How much will this cost?" "When can you get it done?" But, in order to answer those questions with reliable accuracy, you must apply a detailed and disciplined approach and break down the project into its component parts.

## Accuracy Matters

Accurate estimation is important for the following reasons:

- **You want to set proper expectations with prospects and clients from the very beginning.** If the client's vision for the project is larger than the available budget, you are better off knowing that sooner than later.
- **Poor estimates result in project overruns.** Few things upset a client more than a project requiring more time and money than was originally proposed. If your initial estimate is accurate, you can avoid this difficult and stressful situation.
- **A detailed estimate will improve your odds of winning the project.** Being entirely transparent with clients about your estimation process is often a good idea. If a client has to pick between a "back of the napkin" estimation from another firm or a detailed estimation from your firm, the detailed estimation will usually win.

## Best Practices

Estimation is often difficult to do well because there may be unknowns at the time of estimation (i.e. some areas of the project scope may be vague). The more unknowns that exist, the greater the risk that the estimate will be wrong. It is important that the margin of error is adjusted based on the amount of uncertainty at the time of estimation. You do not want to provide a client with a narrow-range fee estimate for a project that has considerable unknowns. There is nothing wrong with giving a client a wide price range for a project so long as you can explain the reasons for the range.

There are sometimes large projects that can't be accurately estimated without a great deal of work. In these situations, it may be best to propose an initial preliminary engagement to capture the full set of business requirements. Clients sometimes need such an engagement to fully explore their needs and options. A few benefits of this sort of engagement are: the client will be forced to think through each requirement and make "in or out" decisions; your ability to accurately estimate the remainder of the work is dramatically improved; and your firm's odds of being selected to deliver the rest of the work are improved.



One important rule of estimation is that it shouldn't be done in a vacuum. Since most projects require diverse skills, it is important to have a representative for each skill involved in the estimation process. For example, an agency building a website might want to involve a representative from project management, user experience design, and engineering. For any large estimates, it is also important for a senior member of the firm to evaluate and discuss the estimation with the estimation team. An estimation miss on a large project usually has a significant negative downstream impact on the firm.

## CHAPTER 2.10

# The Legal Stuff

When your firm is hired to deliver services for a client, you should formalize that relationship with a legal agreement. A contract will protect both parties and clarify the rights and responsibilities of each to ensure that proper expectations are set from the beginning. In the unlikely event that there is a significant dispute during the engagement, the agreement will have a major impact on your course of action and whether or not you get paid for services rendered.

There are several reasons your firm should have a good legal agreement. **Such an agreement will:**

- Describe the services and deliverables that will be provided to the client. Alternatively, the contract may incorporate other documents (such as specifications) that describe the services in detail.
- State the schedule that the services will be delivered upon.
- Identify the bill rates or fixed fee that will be charged for the services. If the fees will accrue on specific milestones, those should be stated.
- Name the roles or, if possible, specific individuals that will provide the services.
- Make clear which party will own the intellectual property (“IP”) being created during the project. If your firm is leveraging its own IP within the solution, that should be stated and the client should be extended a license to that IP but not given ownership of it.
- Identify the payment terms and any penalties for late payment.
- Describe how each side can terminate the contract and if there are any penalties for termination.
- Restrict the client from attempting to directly hire your employees (or vice versa).

- Establish the warranty period within which you will fix any defects at no cost to the customer. Without a good contract, the customer might come back a year later and ask you to fix defects for free.
- Limit your firm's liability to an amount that will not cause unreasonable damage (i.e. to the fees received under the contract in the past 12 months).
- Contain confidentiality and nondisclosure covenants such that neither side can disclose the other's proprietary information and practices.
- State any additional specific obligations of both parties.
- Identify the legal jurisdiction under which the agreement will be governed.

This list above is a brief subset of the topics that should be covered in your standard legal agreement. This is by no means a comprehensive list.

## Agreement Structure and Format

While you could have a single legal document for each and every project, this tends to be inefficient. It is far better to have a single master services agreement (or "MSA") that contains the primary legal covenants and then a statement of work (or "SOW") for each specific project.

Why split up the MSA and SOW? Because the bulk of the legalese will live in the MSA and you'd prefer to only go through legal review once with your clients' lawyers. Since the SOW generally doesn't contain material legal language, it can usually be signed by client sponsors without going through legal review. By splitting up the MSA and SOW, you set your firm up to engage in future projects far more quickly without the latency caused by lawyers.

## CHAPTER 2.11

# The Trusted Advisor

The relationship between a professional services firm and its client is rooted in trust. The client trusts that the firm will provide quality services and deliverables. The firm trusts that the client will make timely payments for those services and deliverables. Each new client relationship that the firm earns will start with minimal trust levels on both sides. After all, trust must be earned. Over the life of the relationship, the firm can earn higher levels of client trust by consistently providing high-quality services and guidance.

A primary goal of firm leaders should be aligning a “trusted advisor” with each strategic client. What is a trusted advisor in a professional services context? A trusted advisor is someone the client trusts to provide honest and accurate guidance that is not biased by the firm’s financial interests. A trusted advisor is a specific person in the firm who is responsible for the client relationship. The firm as a whole is rarely considered a trusted advisor by the client. Clients tend to trust people, not companies.

Not only should the advisor’s recommendations not be geared toward driving firm revenue, but also, the recommendations may actually reduce the near-term revenue from the account. The advisor could recommend that the client not engage in a particular project. Possibly, it would be more cost-effective to purchase an “off the shelf” product rather than build a custom solution. The advisor should always prioritize the client’s interests.

*“Trust is earned in drops and lost in buckets.”*

*Kevin Plank, founder of Under Armour*

There are two primary reasons it is important to become a trusted advisor for clients:

1. **It’s the right thing to do.** Clients need you to help them solve important business challenges in the most effective manner for their business, not yours. It is ethical and right to always provide the best advice, even if that advice is to spend less money with your firm.

**2. It almost always improves revenue potential within the account over the long term.** When clients view your relationship manager as a trusted advisor, they will come to you first any time there is a future project opportunity. Once they know that you place their interests before yours, you'll get first crack at a slew of projects you wouldn't have known about otherwise.

**So, if the goal is to become a trusted advisor, what's the quickest path to getting there?**

Unfortunately, there is no Fast Pass to achieving trusted advisor status. Trust must be earned in small increments and can never be violated. As Kevin Plank, the founder of sportswear company Under Armour, said, "Trust is earned in drops and lost in buckets."

## CHAPTER 2.12

# Invest in Existing Clients

Many professional services firms have the bad habit of underinvesting in existing client relationships. Rather than spend time and money pleasing their current clients, these firms focus their sales and marketing budgets on acquiring net-new logos. They prioritize uncertain prospects over their pool of actively engaged (and paying) clients. This is a mistake, even if those existing clients are small and unlikely to engage in repeat business.

**Here is a good rule to follow if you're trying to build a quality professional services firm: Make sure every client is happy and that your highest-potential clients are thrilled.** When a firm adheres to this simple rule, success is practically a given. It is impossible to overstate the importance of high client satisfaction to the professional services business model. When existing clients are happy, new clients are much easier to come by.

When firms focus too much time and effort on prospecting activities, they fail to create long and enduring relationships with their existing clients. This results in poor client satisfaction, fewer follow-on projects, fewer referrals to new clients, weaker client reference checks, and so forth. Poor client relationships create a steady headwind against the growth of the firm.

Chronically weak client satisfaction often results in a firm culture that prioritizes new client wins. A firm that has inferior existing relationships is like a water bucket with holes in it. There is so much potential revenue leaking out of the bucket at all times that the firm continuously has to scramble to fill it up with new clients. This is a fool's game. Life and financial performance are better when your current clients are happy.

So, how do you invest in existing relationships? **Below are a few best practices. For your highest-potential clients, you should be doing all of the following:**

- **Get your executives involved.** Clients love it when they can speak directly with the CEO or a partner of your firm. Make sure that an executive is participating in a quarterly call, lunch, or meeting.

- **Learn the client's industry and business.** To best serve your clients, you need to understand the opportunities and challenges within their respective industries. You have to put in the work to educate yourself on how their businesses work. Most industries have various trade websites that are filled with perspectives on the future of the industry. Read those and get educated. Also, if a client is publicly traded, read through the quarterly investor conference calls and parse out the pressing questions from analysts.
- **Send out a monthly best practices e-newsletter.** An email newsletter helps reinforce your firm's unique capabilities and knowledge. The newsletter could be focused on a vertical industry or on a specific service line of the firm. Even if some of your clients rarely read the newsletter, it will keep your brand front-of-mind when their next services need arises.
- **Provide free onsite thought leadership sessions.** Once or twice per year, put together a half-day workshop focused on a leading-edge topic that is relevant to a key client's business and industry. Put one or two of your top experts in the room and provide insight that the client might not get anywhere else. The focus could be an introduction to a new technology or a new industry trend. Provide lunch and hand out high-quality printed versions of all presentation materials.
- **Do the basics well.** Periodically take the client sponsor to lunch or dinner, ask insightful questions, set and meet expectations, and so on.

When professional services firms focus most of their business development efforts on new prospects rather than existing clients, it is almost always a sign of trouble. In a healthy firm with happy clients, it is always easier to earn future revenue from existing clients than it is to find and win new clients. Firms that think otherwise are usually hiding from client satisfaction deficiencies.

One caveat to this topic is that if a firm has traditional salespeople, it may be fine to focus those folks solely on new client acquisition. If you've got great hunters, let 'em hunt. But this only works if senior delivery leaders in the firm, who are not day-to-day project personnel, are actively nurturing the existing client relationships.

## CHAPTER 2.13

# Sales Team Compensation

There are hundreds of compensation models for salespeople. Simply put, there is no one-size-fits-all sales compensation strategy for professional services. Rather than recommend a specific model, we will cover some guidelines that you can consider when constructing the right plan for your firm.

It is important to point out that many professional services firms do not have traditional “salespeople”. Some firms are too small to have salespeople, some have a CEO who does the sales, and others have a “partner model” where each partner runs a portfolio of accounts. The makeup of the sales function varies widely and so do the compensation models.

With firms adhering to the partner model, the partner is often responsible for selling new business, managing the executive relationships, and overseeing the portfolio of revenue. These partners generally come from a delivery background and have grown into a role that oversees both sales and delivery for a portion of the firm. Partners are generally going to have a multifaceted compensation plan that pays a portion of the gross profit across their portfolio.

**Below are guidelines you should think through when constructing your sales team compensation model:**

- **A compensation model should always start as a collaborative discussion.**  
Weeks before you create the first draft of the plan, meet with each salesperson individually and discuss the high-level goals and likely plan components. Let the sellers express any concerns with the plan or with the business in general. Also, get an understanding of how much dollar volume each sales rep expects to close in the coming year. If that number is too low or unrealistically high, challenge the rep and find out why.



- **Salespeople should have quotas.** Without a quota, the reps are just “doing the best they can”. This isn’t good because your expectations won’t be clear and likely won’t be met.
- **Make sure the variable compensation (usually commission) is meaningful.** Or, put another way, don’t pay a base salary that’s too high. If the reps are getting 80% of their on-target earnings (or “OTE”) in the form of a base salary, it doesn’t hurt badly enough if they miss their sales quota by a wide margin. It should. If the variable portion of their compensation is seen as just “gravy”, there won’t be enough motivation to drive the results that you need.
- **Put the compensation plan in writing.** The sales leader (or the CEO) should sign the plan and the sales rep should sign the plan. This formalizes the plan and indicates that both parties feel it is fair and achievable.
- **Ensure that the OTE figure is clearly understood.** At the outset of the plan year, the sales rep should clearly understand that with X performance he or she will receive Y in total compensation. The rep should be excited by it and feel that it is achievable.
- **Don’t pay excessively for mediocre performance.** Reps that are underperforming after 6-9 months on the job should likely be fired (unless there are extenuating circumstances). The good ones will always shine within those first 6-9 months.
- **Include “claw backs” in the event of customer defaults or contract terminations.** If a sales rep has been paid commission on a sale that never materializes into revenue, the company should be able to recover that unearned commission. Note that, in most cases, it’s best to simply withhold a portion of future commissions over a number of months in order to slowly recover the unearned amount. It isn’t fair for the rep to absorb the entire hit all at once.
- **Strongly consider paying commissions on proposed gross profit instead of topline revenue.** Why? If a rep sells a \$1M project but at a \$50 per hour bill rate, there is likely zero profit in the deal. Companies pay their operating expenses with gross profit, not with topline revenue. By paying salespeople commissions on proposed gross profit, the sales rep is incentivized to make sure that the deal

makes sound economic sense for the firm. Note that the word “proposed” is important here. The sales rep likely shouldn’t be compensated on the realized gross profit because the rep has no control over the delivery of the project. If the project team makes mistakes, that isn’t the fault of the sales rep and shouldn’t lower the sales rep’s compensation (particularly if the sales rep wasn’t involved in the estimation process).

- **If the sales rep is truly managing the customer relationship over time, then the rep should continue to earn full commission in future years.** But, in many firms, it makes sense for relationship management to be handled by a delivery leader who is involved with the project work on a daily basis. In those types of firms, the sales reps are primarily focused on new client wins and delivery leaders focus on repeat business within existing accounts. In that model, the sales rep should get full commission for some period of time (possibly two years) and then should receive a much lower commission (possibly a quarter of the original percentage) for that account on a perpetual basis.
- **Include some accelerators and special incentives in the plan.** Salespeople are competitive and they like to achieve goals and be rewarded. Consider cash incentives, vacations, trophies, and similar awards to drive the desired behavior and results.



## CHAPTER 3

# Client Satisfaction

## CHAPTER 3.1

# Satisfaction is about Experience and Expectations

Arguably the most important objective in professional services is to deliver consistently high client satisfaction. When a firm has a reputation for excellent client satisfaction, many aspects of running the business get easier over time. Current clients engage in follow-on projects, new prospects reach out, client referrals happen regularly, references are glowing, it's easier to land key hires, revenue keeps growing, and so on. But when the firm becomes known for poor outcomes and dissatisfied clients, the boulder gets heavier and the hill gets steeper.

## Defining Client Satisfaction

As important as client satisfaction is to all professional services firms, it is surprising how few firm leaders actually know how to define it. Ask a services firm CEO to define client satisfaction and you will likely hear something about “delivering a high-quality work product”. While quality is certainly important to any business, it isn't the whole story when it comes to client satisfaction.

Client satisfaction is the difference between the realized experience and the expected experience.

There are two important distinctions with this definition. First, satisfaction is not simply the client's evaluation of the work product; it is the evaluation of the entire experience. Second, satisfaction is entirely dependent on expectations. Let's discuss both of these in more detail.

The quality of the work product alone is just one element of the client's experience. Experience is about much more than technical execution and proficiency. To determine whether or not your firm is delivering a high-quality experience, ask the following questions about your most recent significant engagement:

- Did you provide meeting materials (i.e. presentation slides, documents, etc.) to client team members at least one day in advance of every meeting or call?
- Did the project manager send detailed status reports on time every week of the engagement?
- Did the project manager walk the client sponsor through each status report over the phone or in person?
- Did the CEO, or another senior leader of your firm, call in to (or preferably visit) the project sponsor every couple of months to check in, get feedback, and offer assistance?
- Were emails received from the client responded to within a couple of hours at most?
- Was your project manager available for those occasional afterhours client calls to address pressing questions?
- Did your team engage in regular face-to-face meetings with the client or communicate via email and phone calls?

These types of questions relate to the client's overall experience and not just the delivered work product. **A high-quality work product is merely table stakes. Experience is what drives client satisfaction.**

Now that we've covered the experience, let's move on to expectations. As an example, let's say you hire a painter to paint your house and you pay \$2,000. You expect the painter to paint the siding, trim, and shutters for that price, and you need the work to be done by next weekend. The painter finishes the job three days late and when you inspect the work, you realize that the shutters and trim weren't painted at all. The experience you realized was far worse than the experience you expected. The result of that will always be low satisfaction – regardless of the industry.

But what if you had hired a painter just to paint your siding for \$1,000. For that low price, you wouldn't expect any other painting to be done. Let's say he completes the work in a single day and, when you examine the house, you realize the trim and shutters have also been painted. You didn't expect that at all, and you're so thrilled that you tip the painter an extra \$200 and

refer him to all of your neighbors. By exceeding your expectations, the painter ensured high client satisfaction and earned a lot more work in your neighborhood.

Setting clear expectations and managing those expectations are at the nucleus of every leading professional services firm. You simply cannot have a sustainable high-performance firm without consistently setting and managing expectations well. Since project managers have the greatest impact on both experience and expectations, the quality of the firm tends to mirror the quality of the project management team.

## CHAPTER 3.2

# Understanding Value Delivery in Professional Services

It is important that your clients feel they are getting a good value by working with your firm. Clients that consistently realize strong value are likely to engage in repeat business and also provide strong “word of mouth” referrals. To deliver solid value, you must first understand how value is defined.

Warren Buffett famously claimed that, “Price is what you pay. Value is what you get.” While this is generally true, we need a more detailed definition. Value is the buyer’s perception of the benefit received, relative to the price paid.

Some people mistakenly confuse “value” with “inexpensive”, but these are different things. It is possible for something that’s very expensive to be of tremendous value and, vice versa, something very inexpensive can be of awful value. If a new Ferrari Spider sports car normally costs \$280,000 but the dealer offers to sell it for \$220,000, that would represent a tremendous value to the right type of buyer.

An important word in our definition of value is “perception”. This is because value is largely in the eye of the beholder. What one buyer perceives as an excellent value could be perceived as a poor value by another buyer. Thus, value isn’t absolute or universal. It is subjective and it depends on the person (or people) making the buying decision.

Sales and marketing personnel within a professional services firm should target buyers that are most likely to perceive a good value by working with the firm. If the firm builds websites for small-to-midsize businesses, it would be a mistake to target large enterprises because they would likely not perceive adequate value. If the firm provides management consulting at very high rates to Fortune 500 clients, it would be a mistake to market those services to small businesses. Thus, a fundamental rule of value in professional services is to pursue clients who are most likely to perceive strong value from your services.

Once you have identified the right type of buyer for your professional services, the next step is to adequately articulate that value through marketing and sales efforts. The “messaging” communicated through the firm’s marketing efforts should resonate with the target audience. With the right messaging, the sales pipeline will get filled with high-potential opportunities.

Throughout the sales process, it is important for firm personnel to substantiate the business benefits that the firm will produce. While the price is easy for any buyer to understand, the business benefit is not. Professional services are not a hard tangible asset (like a Ferrari) and thus, it can be difficult for a buyer to evaluate the business benefit. It is the job of the sales pursuit team to fully articulate each relevant factor that will contribute to the client’s perception of benefit. If this isn’t done well enough, you’ll know because another firm will win the business.

Once the project is won and underway, it is the job of the team’s senior personnel to ensure that proper expectations are being set and met throughout the engagement. When expectations are not clear or are not being met, that almost always results in a weak perception of business benefit and value. Your primary job in professional services is to ensure that clients perceive a strong value from your firm.



### CHAPTER 3.3

# Net Promoter Score (NPS) for Professional Services Firms

Since high client satisfaction is vital to the health and prosperity of professional services firms, it is important to have a reliable means of gauging it. Some firms use lengthy surveys after each engagement while others rely on client relationship managers to evaluate and optimize client satisfaction. There are various mechanisms and the only dire mistake is to not evaluate it at all.

The most popular means of evaluating client satisfaction is through the use of surveys. There are numerous online survey products (such as SurveyMonkey) that make it simple to create a survey, collect responses, and analyze the data. Within an hour or two, you can have a survey out to each of your clients and start collecting responses.

One general rule of surveys is that the more questions you put on the survey, the lower your response rate will be. People are busy and don't have a lot of spare time to fill out essay questions on your 16-page survey. If you want a high response rate, you have to create a concise survey. The challenge is to create a survey that is brief but that will still yield useful and actionable information.

In terms of brevity, the Net Promoter Score (or "NPS") survey wins the day. With NPS, your survey is a single required question, which is "How likely is it that you would recommend our firm to a colleague?" The answer is on a scale of 0 to 10. Following this 0 to 10 selection, you can provide an optional commentary question, which is "What could we change to improve our quality of service?" By keeping the survey short and simple, you will see the response rate improve considerably.

NPS respondents who provide a 9 or 10 score are your "promoters", 7 or 8 scores are your "passives", and scores below 7 represent your "detractors". Your promoters are very satisfied and are likely to do business with your firm in the future as well as provide client referrals. The passives are somewhat on the fence but aren't likely to drive significant new business

for the firm. The detractors aren't happy and will possibly say negative things about your firm to colleagues.

The overall Net Promoter Score is calculated by subtracting the percentage of customers who are detractors from the percentage who are promoters. This yields a score between -100 and 100. As an example, let's say your firm has 80 clients who answered your NPS survey with 67% being promoters, 22% being passives, and 11% being detractors. This would yield an NPS of 56 ( $67 - 11 = 56$ ). An excellent score!

So, what is a good NPS? **It varies by industry but below are ranges that can be used for professional services firms:**

- **0 or below – Poor:** An NPS at or below 0 is a troubling sign. This means that the firm is less likely to have repeat business or referrals to new clients. Big changes need to be made or the firm will struggle.
- **1 to 15 – Decent:** This NPS range shows that the firm is doing some things well and can probably advance to the “good” range with some small improvements.
- **16-50 – Good:** The firm is performing at a high level. While there is still room for improvement, clients are happy and will drive future value (direct or indirect revenue).
- **51-69 – Excellent:** The firm is loved by its clients and is an industry-leader in terms of client satisfaction.
- **70 and above – Outstanding:** Rarefied air. Many firms will never get to this range.

It is important to point out that smaller firms generally have higher NPS figures than larger firms. This is because the founders of smaller firms are still directly involved in most (if not all) of the engagements that the firm undertakes. Quality control is easier in small numbers. As the firm scales and the number of projects grows, it is naturally difficult to keep NPS at the same level. The job of the leadership team is to keep NPS as high as possible throughout the firm's growth stages.

Regularly monitoring client satisfaction is a critical activity for professional services firms. While there are many ways to do this well, the Net Promoter Score is one of the easiest to implement and is quite effective. The firm should survey each client at least once annually and then engage in an internal review of the scores and associated comments. Making one or two improvements per year can have a dramatic impact on year-over-year NPS scores and the health of the business.

## CHAPTER 3.4

# The Relationship Equity Piggy Bank

With the dynamic and customized nature of professional services engagements, it is easy to veer off course. Maybe a key person leaves the team and you can no longer hit the original due date. Maybe there was a disconnect about the project requirements. Maybe the deliverable has some defects that need to be corrected. It is hard to know exactly what will happen, but easy to know that something probably will.

As discussed in another section of Compass, the project manager is the most important role on the project team. No other role has as great an impact on client satisfaction, and client satisfaction controls the success trajectory of the firm. The project manager is indeed the “keeper of the relationship”, which is why firms live and die by the quality of their project managers.

One of the most important jobs of the project manager is to build “relationship equity”. A good way to think of this is that for each client your firm serves, there is a piggy bank in your office with the client’s name on the side of it. As your firm earns the trust and goodwill of a client, relationship pennies get deposited into that client’s piggy bank. You want as many pennies in each piggy bank as possible.

Why is relationship equity important? Because there will come a time when you’ll need to spend it. When the project manager has to deliver bad news to a client, that bad news costs some of the pennies in the piggy bank. The worse the news, the more it costs. If the project manager has set and met expectations, overdelivered at every opportunity, and created a good rapport with the client team, then there will be enough equity in the bank to pay for most mistakes (even big ones). But, if the piggy bank’s balance is low? Well, don’t expect any follow-on work or client referrals.

So, what are some good ways to build relationship equity? **Here are a few:**

- **Be responsive.** If a client contact calls or emails, respond as soon as you can. If the client sends an email after normal business hours and you can take a moment to respond, then do it. This shows the client that they are a top priority.
- **Be reliable.** Set clear expectations and hit those expectations. It sounds easy, but few people do this consistently well.
- **Be personable.** Try to build a relationship with your client contacts that is more than just a vendor/client formality. Ask questions about their lives, their kids, their hobbies, etc. Your clients are normal people – engage them about real-world topics.
- **Be honest.** Candor goes a long way. If a client sponsor asks a question that you don't know the answer to, don't feel bad about saying "I don't know, but I'll get you an answer as soon as I can." Be a straight shooter.
- **Be helpful.** Go out of your way to be helpful. Maybe your client contact is interested in a particular subject matter and you buy her a book from Amazon. Maybe she needs to evaluate a product category for an internal presentation and you do some initial research for her. Simply being helpful is a great way to add pennies to your relationship equity bank.
- **Be positive.** Have a good attitude! When you are positive, excited, and engaged, people will enjoy working with you. Attitude is everything.

Mistakes will be made, and clients realize that. Just make sure that you have enough relationship equity to pay for them. Earn that equity now so that you'll have it to spend later.



## CHAPTER 4

# Employee Satisfaction

## CHAPTER 4.1

# Work-Life Balance

Professional services careers are notorious for requiring long hours. It is common for employees of the large management consulting firms to work 60-70 hours per week (although some of those hours are for travel and client entertainment). These are demanding jobs that have higher-than-average compensation along with a hefty workload. But firm leaders need to look for ways to enable a better work-life balance in order to minimize burnout, improve morale, and decrease voluntary attrition. High attrition rates usually lead to firm underperformance.

It is important to point out that there are numerous professional services fields and the environment and expectations are different in each one. An accounting firm in the U.S. that does tax preparation for local businesses might work 35-hour weeks during the summer but 90-hour weeks from February through April (known as “tax season”). A boutique web design agency might work strictly from its office while a larger agency’s employees fly cross-country week after week. So, the demands and expectations of employees vary considerably by sector and firm.

Before discussing how and why professional services firms should ensure a healthy work-life balance for their employees, we should first define the term. Work-life balance is a state of equilibrium in which the demands of work do not encroach on one’s personal responsibilities and activities. Put simply, when employees have a good work-life balance, they can do their job well while fully enjoying their lives.

## A Day in the Life

As an example of how grueling a consultant’s work can be, let’s look at a sample weekly schedule for a traveling consultant (affectionately known as a “road warrior”):

**Sunday:** Pack clothes for the week, send emails out to the team, work on Monday’s meeting agenda, prepare for the week. (Total time = 3 hours).

**Monday:** Get up at 4 a.m., drive to the airport, fly across the country, go straight to the client's office, work until 6 p.m., team dinner until 8 p.m., check in to the hotel, follow up on emails, collapse in bed. (Total time = 14 hours).

**Tuesday-Thursday:** Team breakfast at 7 a.m., discuss plans for the day, meetings and work sessions throughout the day, mitigate client concerns, client sponsor dinner, team debrief at the hotel, work on client deliverables at night from the room, follow up on emails. (Total time per day = 12-14 hours).

**Friday:** Team breakfast at 7 a.m., half-day at the client's office, head to the airport at 3 p.m., fly back home while working on the plane, drive home at 8 p.m. (Total time = 10 hours).

**Saturday:** Hopefully no work.

A person working this schedule would likely average more than 60-70 working hours per week, and this schedule could exist for months on end. While the working hours may be 60-70 per week, the hours the person is away from home are often well over 100 per week. For most road warriors, there may be a one or two-week break between engagements, but the majority of the year is spent with a schedule like the one above. For consultants earlier in their career, this type of schedule might be doable (even exciting at first), but over time, few people want to live this way.

The largest consultancies are notorious for using a brutal work schedule as an "up or out" mechanism. The consultants who can handle the travel and workload advance up through the organization and eventually make partner. But those who can't endure the grind for months (or years) eventually wash out. This "burn and churn" model worked thirty years ago but is no longer as effective in the age of employee feedback websites like Glassdoor.

## Why a Work-Life Balance is Important

Professional services firms are "people businesses". Essentially all of the revenue generated by the firm comes from the labor of the billable personnel. If the employees all quit tonight, the revenue would be \$0 starting tomorrow morning.

**While there are many success drivers in professional services, two of the most fundamental ones are:**

- **Strong billable utilization:** The firm will maximize revenue by keeping the workforce highly billable.
- **High-quality work:** If work isn't being done at a high level of quality, clients will be dissatisfied. This will result in either non-billable rework or distressed client relationships. Both negatively impact future revenue.

Both of these success drivers are heavily influenced by the voluntary attrition rate of the firm. The voluntary attrition is calculated by dividing the number of employees who left the firm voluntarily over the past year by the average number of employees employed. When the voluntary attrition rate is high, both the utilization rate and the quality of work tend to suffer. When those suffer, both current and future revenues become distressed.

In addition to the pure economic reasons for ensuring a healthy work-life balance for employees, firm leaders should feel an ethical responsibility as well. What type of person wants to earn wealth by driving other people into the ground?

## Ways to Improve Work-Life Balance

Since a healthy work-life balance is good for both the employee and the firm at large, let's discuss some ways to improve it:

- **Remote work** – When employees are not “on the road”, being able to work from home is a big relief. It saves them commute time and is generally a more flexible work structure than being at the office.
- **Encourage vacation and personal leave** – When billable employees hit the bench in-between assignments, recommend that they take some time off, enjoy a vacation, etc.
- **Fridays off** – Within client contracts, negotiate four-day workweeks for travelling onsite personnel. Then, give those employees Fridays off. A three-day weekend can really recharge the batteries.



- **Gym membership** – For employees who are working at the office, it is a nice benefit if they can get a workout in during the business day. Many office buildings have a complimentary gym or the firm can negotiate a discounted rate with a national gym chain (that can also be used when employees travel to remote cities).
- **Childcare** – For workers who are parents, having onsite childcare is an incredible benefit.
- **Social events** – It is important to regularly host company events such as happy hours, dinners, all-hands meetings, and the like. These events are a lot of fun for the entire team. If an employee would rather stay home and spend time with their family, that is fine as well.
- **Special Surprises** – To show your appreciation for employees, have some unannounced surprise events like a Cinco de Mayo party at the office or bring in massage therapists to give free massages. Employee appreciation activities can have a bigger impact when they are unannounced.
- **Free Training** – In-between engagements, many employees like to advance their skills. Pay for training classes, conventions, or seminars, including any travel expenses. These can be “learning vacations” for employees.
- **Limit Overtime** – If employees like to work long hours, that may be fine to an extent. But if it becomes a weekly habit, you should have a conversation with the employee and reduce the risk of burn out.

There are many other tactics that can be deployed to help improve work-life balance. Also, employees will have plenty of ideas that you can capture through an annual employee survey. It is ultimately much better for employees and the long-term prosperity of the firm if employees have a healthy work-life balance.

## CHAPTER 4.2

# Culture as a Competitive Advantage

We all know how important it is for a business to have a competitive advantage. The competitive advantage helps separate a company's products and services from those offered by other companies in the marketplace. The competitive advantage could be singular or it could involve multiple facets ranging from price to features to quality.

As an example, Amazon's competitive advantage is rooted in both convenience and low prices. On Amazon you can quickly find millions of products at attractive prices. Amazon then offers free shipping (with its Prime service) and your items are delivered within a day or two (if not within hours). Amazon spent decades building out the infrastructure that enables it to maximize its competitive advantages of price and convenience.

With professional services firms, the competitive advantage may be comprised of things like industry expertise, reusable intellectual property, brand, and price. But what often goes underestimated as a competitive advantage is the firm's culture.

Before discussing how culture can be a vital component of your competitive advantage, let's first define it. If you ask someone to define their company's culture, you will often get a robotic answer that includes the mission, vision, and values. The problem is that a company's stated mission, vision, and values only matter to the extent that they align with the practiced behaviors of firm leaders.

**Culture is a reflection of the behaviors of company leaders.** Within a company, behavioral patterns run downhill and the behaviors of leaders heavily influence VPs, directors, managers, and eventually every employee. This is why you sometimes hear that a primary responsibility of the CEO is to be the "keeper of the culture". It matters little what is on a motivational poster in the break room, but how firm leaders behave every day matters a lot.

One reason culture is so important within professional services is that it directly impacts the quality of services and deliverables produced for clients. Since the "product" being sold

to clients is through the expertise of employees, it is important to attract and retain the best people in industry.

When a company has a strong and desirable culture, recruiting is easier and attrition is lower. While a high attrition rate will hurt any business, it will have an outsized negative impact on a professional services company. When key employees leave the company, there are high replacement costs related to recruiting, interviewing, onboarding, training, and the like. Moreover, the throughput and quality of client work is damaged any time a key member of the team exits. This damage is more immediate in a professional services company than in most other types of companies.

As we discussed previously, professional services firms are in the business of satisfaction. When client satisfaction is chronically low, it is impossible to build a high-performance firm. It is important to recognize the tight correlation between employee satisfaction and client satisfaction. If employees are not happy, their work will be substandard and their average tenure will be low. Unhappy employees who leave the company will always result in weak client satisfaction and firm underperformance.

Professional services firm leaders need to consistently practice behaviors that are appreciated and respected by the workforce. This doesn't necessarily mean foosball tables and beer on tap (although perks are nice!). It means treating people well while still holding them to a high standard. Leaders who can build a culture around things like candor, empathy, transparency, excellence, respect, and some good old-fashioned fun will enjoy a better business that has loyal employees and happy clients.

## CHAPTER 4.3

# Performance Evaluation with OKRs

People who choose professional services as a career tend to be highly driven. Whether they are recent college graduates or are switching from another industry, they are eager to learn and advance. It is important for professional services firms to have formalized procedures for goal setting, coaching, training, and performance appraisal.

Many firms fail to provide satisfactory performance management programs for their employees. The average favorability of performance practices across industries is a dismal 30%. When employees feel that performance appraisals and associated advancement opportunities are unclear or unfair, they are likely to seek employment elsewhere.

One of the more popular methods for performance appraisals is known as “Objectives and Key Results” or “OKRs”. OKRs were first used by Andy Grove at Intel decades ago but were brought into the mainstream with their adoption at Google. Larry Page (cofounder of Google) claimed, “OKRs have helped lead us to 10x growth, many times over. They’ve helped make our crazily bold mission of ‘organizing the world’s information’ perhaps even achievable. They’ve kept me and the rest of the company on time and on track when it mattered the most.”

OKRs help set the strategy and goals for a period of time (usually a quarter) for teams and individuals. OKRs usually start at the highest level, with the CEO setting specific quarterly OKRs for the company. Each division and department then set their own OKRs that are in alignment with the company OKRs. Ideally, if the divisions successfully achieve their objectives, then the company as a whole will achieve its objectives. Eventually, OKRs make it down to the individual team and employee level.

The “objective” component of OKRs is a clearly defined goal. Each objective may be supported by one or more initiatives. An initiative is a plan with specific activities that will help achieve the objective.

The “key results” component of OKRs are specific measures used to track the achievement of the objective. Key results can’t be subjective and must be measured on a numerical scale (i.e. 0-100%, units, ratings, dollars, etc.). The idea behind numerical key results is that they can be quantitatively measured and easily scored at the end of the performance period. When the results cannot be quantitatively measured, they are open to interpretation, which weakens the effectiveness of any performance management process.

As an example of how OKRs can work in a professional services firm, let’s assume that Bob and his manager are working on his OKRs for the coming quarter. Bob is a software engineer and there have been some customer complaints about the quality of his source code. **The following might be an OKR for Bob for this coming quarter:**

***Objective: Decrease the number of bugs in my code***

***Key Results:***

- *3 or fewer defects per 100 lines of code written*
- *25% decline in the number of defects identified by the Quality Assurance team*
- *0 client complaints about buggy source code*

Note that each of the key results are quantifiable. The assessment of Bob’s performance will be objective and not subjective.

One of the benefits of having OKRs at every level of the organization is that they help tie an individual’s objectives to the overarching goals of the company. When each member of the company vigorously pursues his or her OKRs and those OKRs align with company goals, the cumulative positive impact on overall performance is significant.

## CHAPTER 4.4

# The Anonymous Employee Survey

If you are a leader in a professional services firm and you truly want to know what your employees think, consider providing a quarterly or annual anonymous employee survey. Anonymity gives employees the freedom to respond candidly (and sometimes harshly). While some of the feedback might be tough to hear, as a leader, you need to assess the raw sentiment of the team and develop a plan for improvement.

One of the better ways to survey employees is via questions that require a scored response. For example, answers can fall on a scale from 0 to 5 with 0 meaning “Strongly Disagree” and 5 meaning “Strongly Agree”. After each question, there should be an optional comments box where the employee can go into detail regarding the provided score. The scored response for each question is valuable because it allows for an average score for each survey question across the workforce. The average score helps quickly identify areas where the employees are consistently happy and areas where they are consistently unhappy.

**A few good rules for an annual employee survey process are:**

- **The survey must be truly anonymous.** There should be no IP address tracking, distinct URLs, or any other identifying tactic. Everyone in the company should be able to access the same URL from any device on the company’s network.
- **Commit to sharing the scored answers.** Employees won’t trust a survey process if they aren’t allowed to see the results. Transparency is important – especially in professional services companies. Publish the average score of each survey question for all employees to see within a week or two of the survey closing.
- **Do not share any of the comments.** It should be very clear to employees that any commentary provided will remain confidential. This gives employees the freedom to respond with more specific detail regarding areas (or coworkers) of concern.

- **Commit to action items.** Identify specific areas of employee dissatisfaction and commit to improving two or three pressing areas over the coming year (or quarter). Some improvements can take months to fully execute, and thus, you want to commit to an achievable number.

Employees need to understand that they have a voice in the direction of the firm and that their voice truly matters. The best way to do this is through honesty and transparency. When employees see that real improvements are being made based on survey results, satisfaction and loyalty will increase.



## CHAPTER 5

# Productivity





## CHAPTER 5.1

# The Ins and Outs of Utilization

Utilization is one of the most important metrics in professional services, but it's also one of the most poorly understood. When utilization metrics are calculated and leveraged appropriately, they are incredibly helpful in evaluating the productivity of individual employees and of the team as a whole. But when utilization data is captured and interpreted poorly, it can create angst amongst the team, lead to poor operational decisions, and hurt future performance.

So, what is the general concept of utilization and how is it calculated? Utilization is simply the number of hours worked in a time period divided by the available number of hours. If a machine in a factory is available 24 hours per day, but was only used for 20 hours yesterday, its utilization for yesterday would be 83.33% ( $20 / 24 = 83.33\%$ ). In professional services, we are evaluating humans instead of machines, but the general concept is the same.

To properly evaluate firm productivity, it's important to view utilization through multiple lenses.

## Billable Utilization

When people talk about “utilization” in a professional services context, they are almost always referring to “billable utilization”. This is because billable utilization has a direct correlation to revenue. But, as discussed below, it's a mistake for firm management to only evaluate and publicize billable utilization. Unfortunately, this mistake is made more often than not, by both small and large firms.

Billable utilization is the total number of billable hours worked for clients in a period of time divided by the available hours. If a full-time employee bills 32 hours out of a 40-hour work-week, that employee has a billable utilization of 80% for the week. The math and concept are simple. You can also evaluate the utilization across the company as a whole over any period of time. For example, a services firm with 20 employees delivers 34,000 billable hours over the course of a year out of 41,600 available hours, for a firm-wide billable utilization rate of 81.7%.

But what happens when some of the hours worked for clients aren't billable? Ideally, this won't happen, but it does from time to time. A project may go over its hours budget or some free re-work may be needed. In either case, it is likely that some "free" non-billable hours will be worked on the project. If Susan works 40 hours, but only 20 of those were billable because the project was over budget, she would only have a 50% billable utilization figure even though she worked 40 hours. This is why it is important to look at other utilization metrics beyond billable utilization.

## Client Utilization

"Client Utilization" is similar to billable utilization except that it considers both billable and non-billable client hours. If Susan delivers 32 billable hours and 8 non-billable hours on client work in a given week, she would have billable utilization of 80% and client utilization of 100%.

With client utilization, our denominator remains the same (it is the total available hours in the timeframe). But our numerator is the sum of both the billable and non-billable hours worked for clients.

The reason it is important to evaluate client utilization is because the person whose billable utilization is hurt by the non-billable hours may have had nothing to do with the original cause. An employee may have had no role in the estimation of the project and thus shouldn't be penalized if the project takes longer than planned to complete. Or, a senior employee may be asked to pitch in and "save a project" even though there are no billable hours left. The non-billable hours related to that remediation work would not be the fault of the senior employee.

## Total Utilization

Most employees of consulting firms engage in internal activities from time to time. An employee might be asked to redesign the company's website or build out some training materials. Internal projects are important to the ongoing prosperity of the firm. But what happens to billable utilization and client utilization metrics when employees work on internal efforts? They tank.

When companies only evaluate employee productivity through billable or client utilization, it creates an environment where employees don't want to work on internal projects. Over time,

this has a negative impact on the growth and maturity of the company. Strategic internal projects (such as marketing programs) get pushed off because employees want to stay billable. This is why firm leaders must periodically adjust billable utilization goals and must also monitor “Total Utilization”.

Total utilization includes all hours worked in the numerator (internal plus client hours) with the same denominator of available hours. It indicates the relative volume of hours an employee delivers, regardless of the type of work being done. Let’s look at a simple example to illustrate why evaluating all three utilization metrics is important.

There are 21 business days in March of a given year. Susan is a full-time employee and has 168 available hours in the month. Susan billed 80 hours to clients during the month and had a billable utilization rate of 47.6%. If her company leaders only look at billable utilization, Susan would look like a severe underperformer. But Susan also worked 40 non-billable hours on client projects during the month, helping fix some mistakes made by others. This resulted in client utilization of 71.4%, which is better, but still not highly productive. Evaluating her time entries further, Susan worked 80 hours on a mission-critical marketing project and thus had 200 total hours worked in March for a total utilization figure of 119%. Without evaluating all three utilization metrics, it is impossible to understand how hard Susan was working over the month.

## Adjusting for Time Off

It is important to also evaluate the three main utilization metrics with respect to the time off that the person took during the month. If a person took 40 hours of vacation in a 160-hour month, the “time-off adjusted” version of the utilization figures would use 120 hours in the denominator instead of 160 hours. Without the ability to evaluate the time-off adjusted versions of the utilization figures, it is impossible to gauge relative productivity from month-to-month.

Here is an example to illustrate the importance. If a firm has 20 full-time services personnel and there are 21 business days in December, there are 168 total available hours per person which yields a total of 3,360 hours for the firm. If the team billed 2,200 hours in December, that would result in a billable utilization of 65.5% ( $2,200/3,360 = 65.5\%$ ), which is not good. But each of the 20 delivery personnel took 40 hours off for the holidays and thus the team’s

time-off adjusted billable utilization was 85.9% ( $2200/2560 [3360-800] = 85.9\%$ ), which is much better! By looking at both numbers, we can understand that while December wasn't good in terms of revenue generation, the team actually was highly-productive when not out on vacation.

The time-off adjusted versions of the utilization metrics are the only way to compare the workforce productivity of a month like December (with a lot of vacation) to a month like October (often with very little vacation). It is quite possible that the team worked harder within its available time in December, even though revenue generation was far below October. Without evaluating time-off adjusted utilization metrics, there is no way to compare relative workforce productivity from month-to-month.

## CHAPTER 5.2

# Revenue Backlog

Since achieving target utilization is so crucial to a professional services firm's performance, it is important to understand its drivers. In order to deliver consistently strong utilization, two factors must exist. First, the firm must have a healthy revenue backlog at all times. Second, the firm must have a robust delivery team optimization function that allocates work appropriately to each delivery person in the firm. If management of the backlog or resource pool falters, utilization and revenue will underperform.

The firm's revenue backlog includes all sold work that has yet to be delivered. So, if you sell a \$100,000 project (meaning, the contract is signed), that \$100,000 leaves the sales pipeline and is transferred into the revenue backlog. Let's assume that after the first month of the project delivery, the team has completed 20% of the work. \$20,000 will have exited the backlog and will be recorded in the accounting system (in the revenue portion of the profit and loss statement). At that point, the backlog for the project is \$80,000. This flow of money, from the sales pipeline to the revenue backlog and finally to the profit and loss statement, is fundamental to professional services firms.

The firm must carefully analyze backlog relative to the size of the delivery workforce. Since the backlog is a leading indicator of future revenue, the backlog dollars per resource should be regularly evaluated by firm leadership. If the backlog per resource becomes meaningfully lower than average, this indicates a likelihood of lower future utilization and revenue. But if the backlog per delivery resource becomes abnormally high, this will result in projects taking longer to deliver (which usually has a negative impact on client satisfaction). In times when the backlog per resource is larger than normal, the company should likely be recruiting delivery personnel.

It is important for firm leaders to analyze not just the size of the backlog but also the types of work in the backlog. Many professional services firms are comprised of specialists who deliver a subset of the firm's overall service portfolio. In a web development consultancy, for example, there are project managers, creative designers, software engineers, and other distinct roles. The consultants are usually only capable of delivering work that falls within

the bounds of their particular discipline. Thus, it is possible that a firm could have a large backlog but still not have enough work for certain people on the team. It is important to evaluate the backlog per resource in each of the disciplines (or “utilization silos”) within the firm.

There are two types of work that can exist in the revenue backlog: allocated and unallocated. When a project is sold, the associated revenue goes into the backlog but it probably isn’t yet allocated to specific people. As the unallocated work gets planned out, it typically gets assigned to specific individuals within the firm. While allocating the backlog to specific workers isn’t required, doing so tends to yield higher utilization and better operational performance.

Essentially all high-performance professional services teams have a strong handle on their revenue backlog and a clear understanding of the resource types needed to deliver the backlog.

## CHAPTER 5.3

# Understanding Leverage

Leverage is one of the more common concepts in the professional services industry, but it is often misunderstood. Leverage is commonly correlated with the percentage of junior-level employees in the firm, but it is more about profitability than the employee demographics or organizational model.

Simply put, leverage is the spread between the client bill rate and labor cost for a unit of work. The larger that spread, the higher the profit margin and the greater the leverage. Professional services firms can only improve project gross margin through two means: charging higher rates/fees for the work or delivering the work at a lower labor cost. Since bill rates are somewhat bound by the market forces of supply and demand, it is usually easier for firms to improve profitability by focusing on the cost side of the equation.

Firms that deploy a “leverage model” assign project tasks to the least expensive resource that is capable of delivering the work at the needed level of quality. Senior personnel in a leverage model usually only deliver those tasks that require their high level of experience and expertise. The remainder of their time is focused on overall engagement management, nurturing the client relationship, sales, and keeping the team productive.

Within the past couple of decades, leverage models have evolved to include offshore labor arbitrage. Instead of assigning project tasks to capable junior personnel, firms have been able to drive their labor costs down even further by sending the work to an offshore team (that usually includes junior and senior members). This offshoring trend started with IT services but has since expanded to other professional services segments such as accounting and legal.

Leverage is about maximizing the profitability of the services your firm provides. When the services are complex or require decades of experience to deliver, a senior member of the firm should be assigned to the work in order to ensure a high-quality result. But when tasks are more rote in nature, it is possible to assign a less-experienced and less-expensive person to deliver the work at higher margin.

## Determining the Leverage Model Fit

The most important thing to understand about leverage is that the services mix of the firm determines the amount of leverage possible. In order to assess whether a leverage model is viable for your business, you must first analyze the services and individual tasks that the team delivers. If the overwhelming majority of those services and tasks need to be delivered by an experienced person, there likely isn't much leverage potential in the model. But if a good portion of the services and tasks are more procedural in nature, there is an opportunity for leverage.

Some types of firms have more difficulty deploying a leverage model than others. For example, boutique management consulting firms usually lack significant leverage. In these firms, the client interaction is often with C-level executives and it takes highly-experienced senior personnel to sell and deliver the services. Deploying junior-level employees to execute senior-level work usually results in a poor client experience. Thus, boutique management consultancies rarely have many junior personnel and typically lack leverage.

## Leverage Requires Maturity

As stated above, only firms that have tasks suitable to junior (or offshore) personnel have the option to use a leverage model. But, is a leverage model right for every firm that qualifies?

***Absolutely not!***

While the profitability upside of deploying a leverage model is attractive, it requires a meaningfully higher level of organizational maturity. It's not as simple as hiring a bunch of juniors and throwing them on projects. There is significant organizational weight that comes with a leverage model. Pursuing a leverage model without fully evaluating your firm's readiness will usually hurt profitability and client satisfaction.

When a firm is comprised of highly-experienced personnel, it doesn't require a great deal of administrative overhead. But as junior personnel are added, that changes considerably. Some of the things you must consider when evaluating a leverage model include:

- **Junior employees need managers.** Are your senior employees willing to manage and coach juniors? Some senior people dislike being in the manager role.



- **Junior employees will expect (and deserve) regular performance evaluations.** Juniors want to understand their goals and how to achieve them. They want to know what they are doing well and what they could improve upon. This requires weekly check-ins with managers, annual evaluations, peer reviews, and the like.
- **Utilization will go down for senior personnel.** Given that senior personnel will have many more “overhead tasks” to complete in a leverage model, they will have less time available to bill on client engagements.
- **Inexperience requires process definition.** Whereas senior people may “know how to do everything”, junior people do not. The firm will need a detailed employee handbook of policies and procedures, a well-documented delivery methodology, and similar process artifacts.
- **Leverage models generally correlate into larger headcount firms.** If you have 20 senior employees in your current firm, you could end up with 2-3 times that number in a leverage model. Some firm leaders love that notion, while others would rather keep the team small.
- **Larger firms need larger HR and recruiting functions.** Larger companies need a robust recruiting operation that is able to quickly replace exiting employees or hire for growth. Also, leverage model firms typically need a strong on-campus college recruiting program to attract and hire the best juniors. A side effect of this larger recruiting function is that many more interviews get completed and most of those will require the time of senior-level personnel.
- **Junior personnel will expect training.** Inexperienced hires don’t just want to gain experience via “on the job” training. They will want formal in-house or third-party training to improve their skills.

It is important to realize that the project profitability benefits achieved in a leverage model can be nullified by the additional organizational overhead. While the firm might be delivering much more attractive per-project gross margin, the higher operating expenses to support the model could result in no improvement in net margin. Or worse, the net margin could actually be lower in the leverage model.

At the end of the day, the decision should be based on the leverage potential in the business and the preferences of the firm leaders. If there is a significant portion of tasks (say, 30% or more) that could be delivered by juniors or offshore personnel, it could make sense to deploy a leverage model and take on the additional administrative expense. But if most of the work requires senior-level personnel, deploying a leverage model will likely have no financial benefit and only introduce organizational pain.



## CHAPTER 5.4

# Delivery Team Optimization

Delivery team optimization, or what some call “resource management”, is one of the most important functions in a professional services firm. Delivery team optimization involves aligning team members to appropriate projects via decision criteria. When the job is done well, the firm should produce strong billable utilization (which corresponds to revenue) while maintaining happy clients and employees. Essentially all high-performing professional services firms of scale have a disciplined approach to delivery team optimization.

Delivery team optimization is vital because it impacts the three most important pillars that support high performance in professional services: client satisfaction, employee satisfaction, and revenue generation. The needs in each of these areas can be summarized as follows:

- Clients want a pleasant engagement experience and want their project completed on time, on budget, and with the expected level of quality.
- Employees want to do work that matches their skills and interests, and they expect a reasonable workload.
- Optimal revenue is enabled through consistent billable utilization.

Each of these three pillars above can only be fully satisfied when the right people are assigned to appropriate projects at the ideal time.

## The Utilization Trap

Some firms fall into a bad habit of making project team assignments exclusively through a billable utilization lens. While it is obviously important to get the team highly billable, doing so without considering employee or client satisfaction is a mistake.

When a delivery team member becomes known as a “guru” on a certain type of engagement, that person tends to get assigned to that one engagement type over and over. For some

employees, that consistency may be ideal, but for many others, it can become monotonous. It is critical that the person responsible for assigning team members to projects is aware of the career objectives of each person within the delivery organization.

Also, certain individuals may not be a fit for specific projects or project roles. For example, if you run a software engineering consultancy, putting a backend developer into a project management role might not work out. The engineer might not know the responsibilities of that project manager role and may not have the skills to deliver success.

In general, chasing utilization for utilization's sake will eventually bite you.

## Avoid Excessive Utilization Silos

A common mistake that firms make is to get involved in too many service lines (types of projects) while the firm is still small. This usually happens because the firm leaders don't want to turn down potential revenue. When a firm is experiencing a surplus of bench time, there is a tendency to grasp at any type of project that will "get people billing".

Occasionally delivering a fringe project isn't a problem so long as there is enough skills overlap and the firm can produce a quality work product. But when one or two fringe projects evolve into a new practice, it has the potential to create one or more utilization silos within the firm.

For example, an accounting firm that focuses on corporate tax preparation might have a client who asks the firm to deliver an annual audit. Realizing that there are currently consultants on the bench, the firm leaders agree to do the audit work. A few other clients ask for audits, and the firm starts marketing an audit practice. But as it turns out, the employees who do onsite audit work need a different set of skills than the employees working on tax returns back at the office. The new audit practice has created a utilization silo.

A utilization silo exists any time there is a project role that only a subset of personnel in the firm can satisfy. Almost all firms will have some number of utilization silos because of the distinct roles on project teams. For example, a firm that delivers websites would have utilization silos related to project management, creative design, engineering, and testing. In order for the company to perform well, it must manage high utilization across each of those four distinct skill areas.

The challenge of aligning team members to billable work increases every time there is a new distinct project role within the organization. While most firms want to grow, the best way to do that is by selling projects that can be delivered with the same types of skills that already exist within the company. Each time a new skill is added, the challenge of optimizing utilization across the firm increases.

## Decision Criteria

When assigning personnel to projects, it is important to consider a variety of factors. Too often, the decision is simply based on the skills alone. Here is an overview of some of the factors to consider:

- **Applied skills:** Does the team member have the core skills needed to deliver the work?
- **Presentation and soft skills:** Is this an onsite client-facing engagement or one that can be delivered from the home office? Will there be a lot of meetings or conference calls where the team member will need to speak or present?
- **Writing ability:** Will the project require written deliverables? Is this person a proficient writer? Does this person enjoy writing?
- **Location and travel tolerance:** If the work is onsite, does this team member live in the same city? If not, does the member have travel concerns or restrictions?
- **Foreign language:** Would it be advantageous to assign a member to the project who can speak and write in a particular foreign language?
- **Experience level:** Does this person need to be highly experienced? This can depend on the role as well as the current composition of the project team.
- **Industry domain knowledge:** Does this person have specific expertise within the client's industry? For certain types of engagements and clients, this can be critical.
- **Career path alignment:** Does the work align with this team member's career objectives and goals (as outlined in past performance evaluations)?

- **Leadership:** Will this person be expected to lead a portion of the team? Has this person done that well in the past?
- **Similar past projects:** It can be helpful to have people on the team who have successfully delivered similar projects in the past.

## A Dedicated Function

Delivery optimization is best done by a dedicated person (or team) within the professional services firm. When someone attempts to manage delivery optimization while also being billable, it often results in poor staffing decisions. It takes near continuous attention to optimize the project assignment process effectively.

The person responsible for delivery optimization should report to the delivery leadership of the firm and should also have close coordination with the sales and recruiting teams. It is important to know the types of opportunities that are likely to close in the weeks and months ahead. This information can help plan out future staffing assignments and also inform the recruiting priorities of the firm.



## CHAPTER 6

# Efficiency

## CHAPTER 6.1

# Managing the Bench

One of the most feared words in professional services is the dreaded “bench”. Bench is a term used to describe service delivery employees who are not actively billing on a project. Instead of being in the game, they are stuck on the bench.

Company leaders tend to dislike bench time because it doesn't generate revenue, and it lowers company profitability. Delivery employees dislike bench time because they love their work and want to keep their jobs. Both groups realize that if the firm has too many people on the bench for too long, there will be no choice but to reduce headcount.

**A universal law of professional services is that there will be bench time.** It simply isn't possible to keep everyone fully billable indefinitely. For most professional services firms, bench time isn't just likely, it is preferable. Why would a firm want bench time if it hurts revenue and earnings? **There are a couple of reasons:**

- 1. For a firm to grow, it must be able to take on new projects within a reasonable period of time.** If the delivery organization runs at maximum utilization, it won't be able to handle new work until existing projects finish. Clients generally don't want to wait weeks or months, and thus, they will select another provider with better availability. In order to grow quickly, the firm must have available bench to apply to new projects.
- 2. The company needs to continually deliver strategic internal initiatives.** These projects could range from marketing efforts to process development to productivity tools. Many of the most effective marketing tactics in professional services can only be executed by delivery experts. For example, if the firm is hosting a webinar to attract new prospects, a delivery lead will need to develop the content, create the slides, and rehearse the webinar. If that person is 100% billable, the webinar will be lower quality and less effective.

So, bench time isn't just inevitable, it's desirable. But, as with most things, it is only desirable within reason. Excessive and prolonged bench time causes real problems for the business.



One of the most important tasks of firm leaders is to balance supply and demand to ensure that bench time is in an acceptable range. If the firm has insufficient supply (of available delivery employees), clients will be upset (due to project delays) and revenue will be depressed. If the firm has insufficient demand (not enough client work), too many employees will hit the bench and layoffs will eventually be necessary.

The most effective tool in balancing supply and demand in a professional services firm is the forecast. The forecast is a projection of future business and it is developed by combining the sales pipeline and revenue backlog. The forecast and existing resource allocations directly inform the pace of recruiting and hiring within the firm. With an accurate forecast in hand, firm leaders can manage the bench to a desirable range and maintain a healthy income statement and company culture.

## CHAPTER 6.2

# Effective Bill Rates

One of the more important metrics to monitor in a professional services firm is the effective bill rate. The effective bill rate is calculated by dividing the total revenue generated from a project by the total number of hours worked on it. The total number of hours worked should include both the billable and non-billable hours. Time spent on the sales process or on overall relationship management is generally not included in the effective bill rate calculation.

Why is the effective bill rate metric so important? Because for many firms, it can vary considerably from the proposed (or expected) bill rate of a project. Let's say your firm proposes a 1,000-hour project at \$200 per hour for a total fee of \$200,000. During the project, a junior-level team member makes some mistakes and 200 hours of work need to be redone. Since it wouldn't be fair to charge the customer for those hours, the additional 200 hours are deemed non-billable (worked at no cost to the client). Thus, the \$200,000 in revenue actually required 1,200 hours of work, which yields an effective rate of \$166.67 (which is 16.7% below the originally planned rate).

An advantage of tracking the effective bill rate of each project is that it helps you compare fixed fee engagements with time and materials engagements. Some professional services firms tend to propose engagements on a fixed fee basis with the intention of delivering projects at a higher gross margin. But fixed fee engagements carry various delivery risks (typically related to scope management) that can have a negative impact on the bottom line. If the same \$200,000 project above was proposed on a fixed fee basis but took 2,000 hours to deliver, its effective bill rate would be \$100 per hour. By monitoring the effective bill rates of all projects, firm leadership can ascertain the project types that yield the highest profit margins.

## Actual-to-Plan Effective Rate Variance

Monitoring the effective bill rate by itself is useful to professional services firms that deliver similar types of engagements with a standard project team composition. When the entire portfolio of projects is monolithic, the effective bill rate is a good way to compare the

performance of one project to the next. But when the projects and project team structure vary, the effective bill rate can no longer be used as a standalone benchmark.

Let's assume a software engineering consultancy has just completed two projects. Project A resulted in an effective bill rate of \$125 per hour while Project B resulted in an effective bill rate of \$90 per hour. Project A is a much better project, right? Maybe, but maybe not. If Project B was primarily delivered by an offshore team at a much lower labor cost, it could have a higher gross margin than Project A.

**When evaluating effective rates, what is most important is the variance between a project's planned effective rate and its actual effective rate.** When a project is first estimated, you should have a decent understanding of the expected roles, tasks, hours, revenue, costs, and profit. By the time that project is resourced and ready to begin, the planned effective rate should be highly accurate.

Ideally, you want every project to have a planned effective rate at the outset so that you can monitor the variance to plan throughout the project. In our previous example, if Project A had a planned effective rate of \$150 and Project B had a planned effective rate of \$80, it becomes clear that Project B was managed better to plan. Firms with widely-varying labor costs (such as leverage models or offshore models) should focus heavily on the effective rate variance to plan.

## CHAPTER 6.3

# The Most Important Role on a Project Team

Projects live and die by the quality of their project managers. That might sound extreme, but on the whole, it's true. No other role on a project team has the ability to influence success or failure to the level that the project manager does. While you want high-quality people across your professional services organization, make sure that each and every project manager is outstanding. **Project managers are ultimately the governors of profit and client satisfaction, and those two things control the success trajectory of your firm.**

So, why is the project manager role more important than other roles on the team? After all, a project team could consist of 10 or 20 people. Most of those people contribute directly to the work product whereas the project manager may have a more indirect role. How could a person who oversees tasks be more vital than the people actually delivering those tasks? We'll dive into some of the reasons below.

## Expectation Management

Professional services are largely about setting expectations, managing expectations, and delivering to those expectations. As stated earlier in Compass, client satisfaction is the difference between the realized experience and the expected experience. Half of the challenge is setting and managing expectations; the other half is delivering on those expectations. The project manager is the one person on the project team who can regularly set and manage expectations with all project stakeholders.

One of the primary means of managing expectations is with a weekly status report and subsequent phone call. The project manager should consistently provide this status report to the project sponsor, if not to all project stakeholders. Additionally, the project manager should host a brief phone call to walk the sponsor through the report each week. The report and call should highlight progress, concerns, questions, and areas of risk. By doing this, the project manager ensures that there are no "big surprises" that get dropped on the client downstream. Big surprises generally correlate to a negative experience from the client's perspective.

## Chief Communicator

The project manager is generally the voice of the team. While individual team members may have a direct communication channel with specific client personnel, the project manager is usually the official spokesperson of the team. Thus, the project manager sets the tone and cadence of the communication with the client. The personality of the entire project team is conveyed in how the project manager communicates. It is imperative that the project manager have excellent communication skills and that the communication is clear, concise, and accurate.

You want project managers who are engaged, personable, and optimistic. The attitude of the project manager is infectious and will heavily influence the morale and outlook of both the project team and the client team. While the project manager should certainly be grounded in reality, he or she should be energized and positive about the work at hand. That attitude should be palpable to everyone who is involved with the project.

## The Big Picture

The project manager is the one person on the team who is responsible for monitoring the overall health of the project. While others on the team are focused on delivering their specific set of tasks, the project manager evaluates how all of the tasks across the project are coming along. On a software project, for example, the designers might not realize that the engineers are woefully behind on their development work. The engineers may not realize the designers are waiting on them. But the project manager operates at a higher level and can survey the entire set of tasks and team members.

## Problem Identification and Remediation

A generally accepted principle of project delivery is that **the longer a problem festers, the more expensive it will be to fix**. While this is a common mantra with software engineering projects, it generally applies to all types of professional services engagements. It is vital to identify problems early and then expeditiously develop and execute a remediation plan. Project managers must be acutely aware of project challenges as soon as they present themselves. When problems linger, they almost always have a negative impact on client satisfaction and project profitability.

Since the project manager has visibility into all tasks and personnel on the project, the manager is the best person to identify problems early and develop a plan of attack. If a particular team member is falling behind or delivering defective work, the project manager must identify that problem quickly and mitigate the risk. This often requires the project manager to solicit assistance from other senior members of the firm who have expertise in the problem area. In extreme cases, the project manager may need to replace an underperforming member of the project team in order to protect the outcome and quality of the deliverables.

## The Train Conductor

Good project managers keep the trains running on time. They do this by accurately planning out project tasks (often with the assistance of others) and ensuring that appropriate team members deliver those tasks at the needed time. With potentially dozens of interdependent tasks in motion at any given time, the project manager must be highly-organized and disciplined to manage the entire body of work successfully.

When a professional services firm has capable project managers, it is substantially easier to allocate work to team members in a manner that will yield maximum billable utilization (and maximum revenue for the firm). In many firms, there is a separate resourcing function that is responsible for coordinating work for the entire service delivery organization. The goal of that resourcing team is to align appropriate personnel to projects and maximize the overall billable utilization of the firm. That job is made markedly easier with a strong pool of project managers.

## Yes, it's a Billable Role!

Given the reasons stated above, the project manager is the most critical role on just about every project of moderate or large size. Subsequently, all of the tasks completed by the project manager should be billable. Do not allow a client to suggest that project managers just do “busy work”. If the client sponsor was delivering the project internally, he or she would certainly assign a capable project manager to run it. When a client doesn't want to pay for project management effort, it is a red flag and usually an indication of other engagement problems down the road. If you can't educate the client on the importance of the role and its billability, just pass on the work.

## CHAPTER 6.4

# The Importance of Process

Nearly all companies strive to grow revenue and earnings. Entrepreneurs and executives like to put points on the scoreboard, and the way you do that in business is through growth. In professional services, revenue and earnings growth require additional sales, employees, and processes. While most firms focus on sales and recruiting, many underinvest in process development and eventually pay a penalty for doing so.

Revenue potential in services firms is tied directly to the headcount of the service delivery organization. Since firms are essentially selling the expertise that their employees bring to a unit of time, the only way to grow services revenue is to increase either bill rates or billable capacity. This correlation between headcount and revenue potential is more pronounced in professional services than in any other industry.

The result of the “people-heavy” revenue structure is that professional services firms often have more employees than companies in other industries with similar total revenue. As an example, a SaaS software company could conceivably get to \$10M+ in revenue with 20 or fewer employees. Once the product is built, the company can sell it many times while needing minimal additional personnel. But a professional services company with 75% billable utilization and a \$125 hourly effective bill rate, would need more than 60 employees to reach the same \$10M in revenue (assuming 50 billable employees and 10 non-billable). So, the services company would need three times the headcount of the product company to reach the same revenue amount.

The amount of process definition needed within a company is not a factor of the revenue being generated; it is a factor of the headcount. Companies with greater headcount, regardless of the industry, need more process rigor. A 20-person company can get by with minimal processes but won't be able to scale to 100 employees without process maturity. **For a professional services firm to scale, it must define and follow processes that will foster operational consistency across the organization.**

# Employee Handbook

It is useful for professional services firm leaders to codify the firm's key information, policies, and procedures within an employee handbook. The handbook could be a physical document that is provided to each employee, or it could be an online resource (which is easier to update regularly). The handbook becomes the primary resource that employees refer to when they have common organizational questions.

The employee handbook is particularly valuable to new hires who are often “drinking through a fire hose” to learn what is expected of them. During their orientation period, new hires should be walked through the entire employee handbook to ensure all common practices are clearly understood.

**A good employee handbook usually contains some or all of the following information:**

- What the company does and the types of clients it serves
- History of the company
- Background of the founders
- The mission, vision, and values
- Philosophies and points of view
- Description of primary products and services
- Organizational structure including departments, practices, and job titles
- Performance evaluation process
- Vacation, holiday, and sick leave policies
- Legal policies (such as EEO or FMLA)
- Benefits and perks
- Overview of internal tools and systems
- Bonus plan details
- Employee referral incentives



- Work from home policy
- Expense policy
- Training programs
- Payroll process
- Employee code of conduct
- Facilities information (office locations and related details)

## Delivery Methodology

A delivery methodology is simply a set of processes and artifacts that a professional services firm uses to deliver its projects. The purpose of a methodology is to ensure consistent service delivery and deliverable construction across different teams within the firm. When service delivery is consistent, so are project outcomes, in terms of quality and budget attainment.

An established set of delivery processes also makes it is easier to move personnel from one project team to another or to form entirely new teams with employees who may not have worked together previously.

## Process Library

Some professional services firms become highly-disciplined in their process definition and opt to move all operational processes into a standalone system (and out of the employee handbook). These firms often have hundreds of process artifacts that get cataloged in a “wiki” structure (similar to Wikipedia). This can be an excellent step for services firms that are looking to scale to hundreds or thousands of employees. Since wiki systems are easily searchable, they become the “go-to” source for employees who need to answer operational questions.

## CHAPTER 6.5

# Gross Margin

Gross margin is one of the most important metrics across all types of businesses. Many investors in public and private companies weigh gross margin heavily in valuation calculations and investment decisions. For professional services firm leaders, it is critical to understand gross margin and track it at a few specific levels within the firm.

**Before tackling the concept of gross margin, we first must first define a couple of other accounting terms:**

- **Cost of Services Sold (or “COSS”)** – The COSS is the total cost of delivering the services to the customer. In a product company, this is referred to as the Cost of Goods Sold (or “COGS”) and can more generally be referred to as the Cost of Revenue (or “COR”). Any cost that you incur to deliver services to your clients goes into the COSS figure. This primarily includes the labor costs of the delivery personnel (including payroll taxes and benefits) but it can also include sales commissions, shipping costs, and the like. If you removed any element of COSS, you wouldn't be able to deliver services to clients in the current manner.
- **Gross Profit** – The gross profit is simply the revenue generated from services minus the COSS. So, if a project generates \$200,000 in services revenue and costs \$125,000, the gross profit would be \$75,000.

To calculate gross margin, we simply divide the gross profit by the services revenue. In our example above, the \$75,000 in gross profit would be divided by the \$200,000 in services revenue to yield a gross margin figure of 37.5%. Note that gross profit is always expressed in terms of dollars while gross margin is a percentage.

At first blush, \$75,000 of “profit” on a \$200,000 project might seem like a fantastic outcome. But that \$75,000 is before the company has paid any of its operating expenses related to sales, marketing, accounting, human resources, administration, legal, income taxes, office leases, and other related expenditures. By the time all of those other costs are absorbed, the \$75,000 in profit could be zero, or less than zero.

Different companies can have vastly different operating expenses and thus a gross margin of 37.5% might be low for one firm and high for another. For example, if Firm A has 5 salespeople, a CFO, a controller, 5 marketers, and a lot of office space in a premium part of town, it could easily be losing money on a gross margin of 37.5%. But Firm B may run remotely (no office space), have no salespeople, a junior marketing person, one HR leader, and an outsourced accountant. Firm B has tiny operating expenses compared to Firm A and could generate a healthy operating profit on the same 37.5% gross margin.

## Where to Measure Gross Margin

For services companies, it is important to measure gross margin in three distinct areas – at the individual project level, the practice or project type level, and the firm level. Each of these are covered below:

- **Project Level** – Project Gross Margin allows you to compare one project to another. If one project has a 40% gross margin and a similar type of project has a 20% gross margin, it likely indicates trouble with the second project. It is important to compare projects of similar types and also compare projects to their estimated (planned) gross margin. Before a project has begun, it should have a planned gross margin and the project manager should track performance against that margin throughout the project. Note that it may not be useful to compare the gross margin of projects of different types. For example, a staff augmentation contract will likely have low gross margin but minimal risk and maximum billable utilization over a long period of time. So, it's okay for that staff augmentation project to have a lower gross margin than a traditional project that is shorter in length and carries additional risk elements (like “scope creep” and bench time after the project ends).
- **Practice Level** – If the professional services firm is large enough to have different practices or different types of projects, it is useful to track gross margin across those practices or types. For example, if a management consulting firm has a Mergers & Acquisitions practice and a Spend Optimization practice, it is helpful to evaluate the gross profit and gross margin of each practice. These figures can inform company leaders as to which practice to prioritize in terms of growth investment.

- **Company Level** – At this level, the gross margin is a roll-up of all of the services revenue and costs over a period of time. By analyzing gross margin at the company level, firm leaders can compare one financial period to another (i.e. Q4 this year compared to Q4 last year).

It is nearly impossible to make intelligent strategic business decisions without a solid understanding of gross margin. It is imperative that company leaders understand the concept and work with their controller or CFO to ensure that it is being tracked accurately at each of the three levels above.



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