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Central Government's use of consultants: Market Analysis

A paper presented to the NAO by Fiona Czerniawska

CONTENTS **PAGE**

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Reference:

Fiona Czerniawska is a leading authority on the consulting industry. She is the founder and managing director of Arkimeda, a firm that specializes in researching and consulting on strategic issues in the consulting industry and is the Director of the UK Management Consultancies Association's Think Tank. Her most recent books are Business Consulting: A Guide to How it Works and How to Make it Work (with Gilbert Toppin) and The Trusted Firm.

Section 1: Trends in the market for consulting

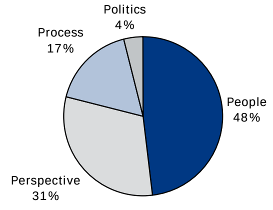
The rationale for consultants

1 According to the Management Consultancies Association (MCA), there are four fundamental reasons why organisations use consultants[1]. Short, comparatively simple projects may be motivated by just one of these; larger more complex projects may be driven by a combination.

People: Gaining access to specialist skills and additional resources lacking internally is the single most important reason for bringing consultants in and account for nearly half of all consulting work (**Figure 1**). David Maister has argued that these skills/resources take three forms: "grey hairs", hired because they have experience in dealing with a particular problem and know how to resolve it; "brains", hired for their analytical skills; and "procedure" people who know how to do something and can deliver it effectively[2].

Perspective: Coming in from the outside, consultants bring a different perspective. This may take the form of objective or independent input into a difficult decision, innovative thinking and/or the gathering and analysis of new information. Here, the role of the consultant is essentially to help organisations make better decisions, not to implement them.

1. Breakdown of consulting projects, by reason for using consultants



Source: MCA, 2006

Process: Organisations may have the information and resources they need to complete a project but are not sure how best to go about it, so they use consultants to help complete the project. The role consultants play in this context is much more hands-on: they may bring a methodology for working or the focus and commitment to see a difficult project through to its conclusion.

Politics: Organisations also use consultants for internal political reasons. By bringing consultants in they hope to precipitate action: to force through an unpopular measure or to push managers into making a decision they have shied away from.

An economy that makes greater use of consultants

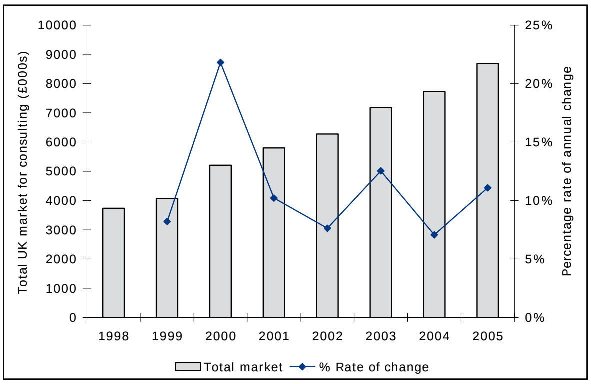
2 The last ten years have seen a rapid and unprecedented growth in the use of management consultants. Having expanded consistently but slowly in the late 1980s and first half of the 1990s, the consulting industry in the UK grew from £3.7 billion in 1998 to £8.7 billion in 2005[3] (**Figure 2**).

[1] *Ensuring Sustainable Value from Consultants* (MCA, 2006). Other studies report similar findings: see, for example, Alan Simon and Vanya Kumar, "Client Views on Strategic Capabilities Which Lead to Management Consulting Success", *Management Decision*, 2001

[2] *Managing the Professional Service Firm* (New York, 1993)

[3] MCA

2. Growth in the UK consulting market 1998-2005



Source: MCA

3 Initially, most of this increase came from private sector companies. Between 1994 and 2001, private sector demand for consulting grew on average by more than 30 per cent each year, compared to an average growth of just over 10 per cent in the public sector[4]. Demand among private sector companies was driven by four factors:

- **A growing economy:** Consulting is discretionary expenditure: organisations are under no statutory or regulatory requirement to use consultants. It follows that they only bring consultants in when they can afford to do so.

- **Technology:** The increasing complexity of doing business, combined with the need to simplify organisational structures, created a demand for a new generation of integrated software systems capable of linking disparate parts of a business together. Such systems took months – in some cases, years – to implement and few organisations had the skills or the capacity to carry out all the work involved. Increasing internet usage made the situation worse, as companies struggled to understand how best to respond to the opportunities and threats posed by going online. On average since 1998, the fee income from IT consulting earned by members of the UK's Management Consultancies Association has risen by 15 per cent per year, from £748 million in 1998 to £1,635 million in 2005.

- **Controls on recruitment and budgets:** Having been through two recessions since the start of the 1980s, the private sector in the mid-1990s had already been through waves of cost-cutting and redundancies, making them short-staffed, especially when it came to new, specialist skills. Furthermore, many companies sought to maintain control over their expenditure by restricting headcount. Unable to find the skills they needed in-house or to recruit new staff, managers turned to consulting firms to fill the gap. This cycle in which managers, under pressure to deliver more, have used consultants to circumvent budgetary constraints has been repeated several times. "Consultants [have been] used as the extension of in-house resources when there were headcount restrictions and/or skills shortage, in effect as a pseudo-variable cost. [Organisations] used consultants as a means of balancing fixed and variable costs."[5]

- **Changing management philosophy:** Having invested heavily in technology, many companies rapidly became disillusioned with the results: the new systems took longer to install and cost more than expected; the productivity gains were less so. Poor return on investment, combined with the pressure to cut costs, challenged notions of vertical integration and managers became more willing to buy in services from external suppliers rather than build their own, in-house teams. "Consultants flourish where the benefits from economies of knowledge outweigh the costs of external contracting. In each case, an executive's decision about whether to use consultants or to tackle problems internally [depend] on the consultant's incremental expense: an estimate of the relative transaction costs. Executives [face] a 'make or buy' decision, forcing them to weigh the scale advantages of outside vendors against the contractual efficiency of internal administration."[6]

4 However, between 2001 and 2004, as worries over the return on investment in new technology grew and as managers increasingly faced restrictions on their overall budget, not just their headcount, the growth in private sector demand for consulting slowed, to an average of just 11 per cent per year.

5 At the same time, demand for consulting in public sector rose steeply: over the same four years, demand for consulting across all parts of the public sector grew by an average of 58 per

[4] MCA

[5] Ahmad Abu El-Ata, former Head of IT for Europe, the Middle East and Africa at Credit Suisse First Boston, quoted in Gilbert Toppin and Fiona Czerniawska, *Business Consulting: A Guide to How it Works and How to Make it Work* (Economist Books, 2005)

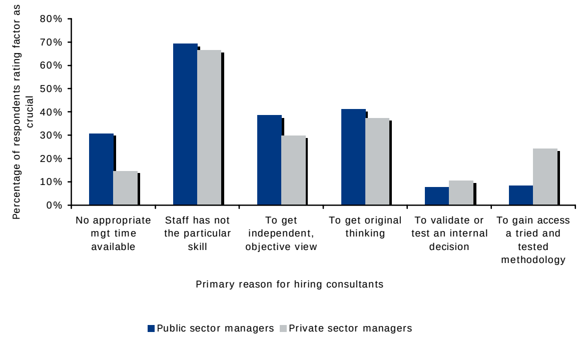
[6] Christopher McKenna, *The World's Newest Profession: Management Consulting in the Twentieth Century* (Cambridge, 2006)

cent per year.[7] The drivers for growth here have been:

- **Government initiatives to modernise and improve the quality and efficiency of public service delivery:** for example Connecting for Health in the National Health Service, implementation of more sophisticated financial management systems, an increased focus on citizen-orientated services, and increased use of IT-enabled services are all initiatives that require additional capability and capacity that may not exist internally within public sector organisations. Such initiatives have created significant pressure on civil servants to deliver major projects at a time when they are being asked to cut resources and costs: "Government clients, anxious to provide better service to citizens but lacking in-depth knowledge… have been particularly susceptible to complete reliance on outside expertise."[8] In such circumstances, bringing in consultants may appear to be the only solution: "[Consulting] becomes more and more attractive to managers as they also come under increasing pressure from their superiors to find new ways of dealing with organisational problems with minimal risk and investment."[9] As one public sector IT director put it: "I have made regular use of consultants in various jobs over the last 10 years, and I can say, without any doubt, that most of the projects I have been involved with would not have been delivered without them."[10]

- **Lack of in-house skills:** Just as much as the private sector, public sector institutions had been subjected to budgetary pressure, making recruitment difficult. Particularly scarce were the skills in demand for these programmes – large-scale project management, technical expertise and experience of working in comparable programmes in the private sector. A 2005 survey[11] showed that public sector managers, like their counterparts in the private sector, rated access to specialist skills as their primary reason for using consultants. Indeed, managers in the public sector were slightly more likely than those in the private sector to rate this reason as "crucial" (**Figure 3**). "Consulting firms provide a pool of people whose input we need but whose skills we cannot and do not want to replicate."[12]

3. Comparing the reasons for using consultants in the public and private sectors



Source: Management Consultancies Association 2005

- **A wider acceptance at a policy level of greater private sector involvement in the public sector:** The combination of policy-driven change and the perception that relevant internal expertise was scarce made it inevitable that civil service managers should turn to private sector companies in order to be able to meet the demands made on it. Moreover, government policy appeared to endorse this: "Providers must be allowed to contest provision and commission from different sources where they believe it to be in the interests of the user", Tony Blair.[13]

- **Excess supply:** While demand in private and public sector consulting is not absolutely counter-cyclical, public sector consulting has tended to grow more slowly or shrink in periods when the private sector consulting market is expanding rapidly, and grow when demand in the private sector is depressed (**Figure 4**). Falling demand in one part of the economy means that consulting firms have sought to maintain their growth, utilisation rates (percentage of available time spent on income-generating work) and profits by finding work elsewhere.

[7] MCA

[8] Alan M Glassman and Morley A Winograd, "Public Sector Consultation", in *The Contemporary Consultant: Insights from World Experts*, edited by Larry Greiner and Flemming Poulfelt (Mason, Ohio, 2005)

[9] John Gill and Sue Whittle, "Management by Panacea: Accounting for Transcience", *Journal of Management Studies*, 1993

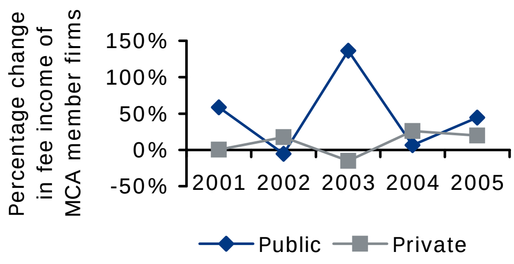
[10] Barry Glassberg, interviewed in Gilbert Toppin and Fiona Czerniawska's *Business Consulting: A Guide to How it Works and How to Make it Work* (Economist Books, 2005) when he was Director of E-Services at the Inland Revenue

[11] *Perceptions of Consultancy in 2005* (MCA, 2005)

[12] Public sector IT director, quoted in Fiona Czerniawska, *The Intelligent Client: Managing Your Management Consultant* (London, 2002)

[13] Tony Blair, "21st Century Public Services", 6 June 2006

4. Comparison of percentage annual changes in fee income of MCA member firms 2001-2005 from private and public sector consulting



Source: MCA

The changing shape of "consulting"

6 This period of unprecedented growth in consulting has also been one of significant structural change for the industry, change which continues to have ramifications for the way in which organisations use consultants and the relationship between consulting firms and their clients.

7 These structural adjustments have taken place over three distinct phases:

- The 1990s – the shift from "advising" to "doing": Although the stereotypical image of a consultant is of someone who advises organisations but is not directly responsible for the implementation of that advice, it is an image which was out of date even 20 years ago. In 1989, the head of consulting at what was then PriceWaterhouse, said that the future of consulting lay in "offering to do everything that a company doesn't want to do for itself. In other words, a client may say to us: 'We are in the business of making soap, not running computers. We want to concentrate on our core business, so you run the computers for us.'"[14]

  Client dissatisfaction with consultants who wrote un-implementable reports had put consulting firms under pressure to change their approach and become more accountable for their work. Technology had created new opportunities for consulting firms, removing much of the industry from its craft origins to a more industrial model. "The proliferation of computer systems, the increasing use of minis as well as mainframes, and the focus on bringing down costs all meant our services were in demand as never before. Technology changes created a tremendous amount of work both directly and indirectly."[15] By the late 1990s, consultants were as much "doers" as advisers: for every £1 MCA member firms earned from strategy work in 1999, they earned £3 from IT work.[16]

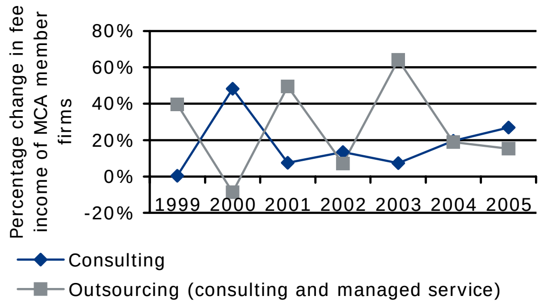
- **Late 1990s / early 2000s - The growth of outsourcing:** The late 1990s also saw a growth in outsourcing in the UK private sector, where responsibility for managing a particular business function was handed over to a third party. This boosted fee income for consulting firms at a time when advisory and implementation work was relatively thin on the ground. Indeed, without outsourcing-related activity (both consulting around outsourcing deals and the delivery of the outsourced service) to boost income, the private sector consulting market in 2003 would have shrunk by 15 per cent. By 2005, almost half the firms belonging to the MCA were involved in outsourcing in some way: 36 per cent were providing outsourcing services, and another 13 per cent were offering consulting advice on outsourcing deals.

  The subsequent diversification of some consulting firms into outsourcing made sense because demand for consulting and outsourcing appears counter-cyclical. Outsourcing can be seen as a means of cutting costs when times are bad, whereas consulting can be viewed as discretionary expenditure, undertaken when organisations have money to invest. The evidence would appear to support this conjecture: thus, the decline in outsourcing in 1999-2000 took place at a time when consulting was growing rapidly while a slowdown in rate of consulting growth in 2002-03 coincided with a rapid increase in outsourcing (**Figure 5**).

[14] *Director*, June 1989

[15] Brian Tash, PKF, quoted in *A Better Place to Be: How the Last 50 Years Has Changed the UK Consulting Industry* (MCA 2006)
[16] *President's Statement and Annual Report* (MCA, 2000)

5. Percentage change in MCA fee income in consulting and outsourcing



Source: MCA

- **2005 onwards:** More recently, the lower rate of growth in outsourcing (15 per cent in 2005) has been accompanied by a surge of activity in consulting (up 43 per cent in 2005).[17] Client concerns that the independent, advisory role of consultants has been compromised by firms' dependence on IT and outsourcing-related work, combined with the re-entry into the consulting market of the three "Big Four" accounting firms who had divested their consulting practices around the millennium (Ernst & Young, KPMG and PricewaterhouseCoopers), has meant that "client-side" advisory work is enjoying a renaissance:

  We're re-entering the market at a time where there's a big space for independent and objective advice which clients don't think they can get from IT and systems integration firms. Our aim is to provide that advice and to act as a bridge between clients and those suppliers.[18]

8 The close, counterbalancing relationship between outsourcing and "classic" management consulting has had a profound effect on the relationship between clients and consultants:

- Confusion of roles: That consultants can be both advisers and doers (outsourcers and IT implementers) makes it more likely that consultants will be involved in long-term projects and provides a new, potentially highly lucrative means of selling additional work (**section 2**). But from a client's point of view, the effect has been to create confusion about what consultants are and how they can most effectively be used. This in turn has led to uncertainty about how to categorise costs: much expenditure is classed as consulting simply by virtue of the fact it is done by what are perceived to be consulting firms.

- **Polarisation of supply:** The UK consulting industry now consists of two distinct types of firm: firms offering a combination of advisory, implementation and outsourcing services, and those providing specialist, advisory services but no implementation or outsourcing. This has provided a choice for clients concerned about conflicts of interest, but has also resulted in a situation where clients can (and do) hire consultants to review and/or oversee the work of other consultants, in some cases taking on responsibilities that were previously exercised by clients themselves.

The profile of public sector consulting

9 The type of consulting services being purchased by the public sector also varies from that of the private sector in some, though not all, the major areas of expenditure (**Figures 6 and 7**):

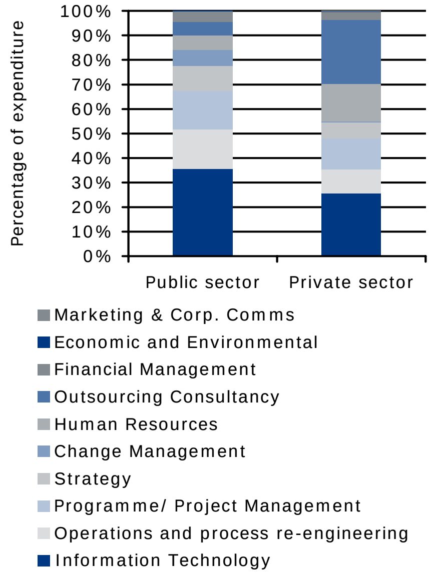
- Information technology consulting accounts for similar levels of expenditure in both the public and private sectors; this is also true so far as spending on project and programme management consulting.

- Expenditure on operations and process re-engineering is substantially higher in the public sector, as is that on change management.

- However, expenditure on outsourcing-related consulting and human resource consulting is lower in the public sector.

[17] *MCA Industry Report 2005-06*
[18] Nick Land, former Chairman, Ernst & Young, quoted in the *MCA Industry Report 2005-06*

6. Comparing the breakdown of expenditure on consulting in 2005, private versus public sector



Source: MCA and NAO estimates based on industry data

- **Information technology:** The public sector spent just over £1 billion on IT-related consulting in 2005. As has been the case for the last four years (the only years for which detailed data is available), this level of expenditure was significantly higher as a proportion of total consultancy spend in the public sector to that in the private sector (36 per cent compared to 26 per cent in the private sector in 2005).[19] Moreover, over this period (2001 to 2005) the absolute value of expenditure on IT consulting in the public sector in total has risen by almost than 250 per cent, compared to just 1 per cent growth in the private sector.[20] There are two main reasons for this variance in expenditure. First is the impact of Connecting for Health. While central government departments' and executive agencies' expenditure has risen from £235 million in 2002 to £529 million in 2005, the majority of the growth has been driven by Connecting for Health, the consulting part of which cost £375 million in 2005.[21] Indeed, total expenditure by the NHS on consultancy was £10 million in 2002. This means that the proportion of IT consulting bought by central government has fallen from 87 per cent in 2002 to 59 per cent in 2005. By contrast, IT consulting in the National Health Service has risen from 2 per cent to 29 per cent of the total. Second, outsourcing (much of which is IT-related) is far more prevalent in the private sector than in the public sector (see below), meaning that less IT consulting work is required in the private sector.

- **Operations and process re-engineering:** Just over 16 per cent of public sector expenditure on consultants in 2005 went on operational improvement work, compared to 10 per cent in the private sector, and making it the second most sizeable area of spend on consultants (compared to the fifth such area in the private sector). Overall expenditure has risen from £71 million in 2002 to £469 million in 2005, a six-fold increase and ten times faster than the increase in private sector expenditure in this area. As with expenditure on IT consulting, this type of consulting is closely linked to the government's agenda for improving the quality and efficiency of public services: central government accounts for almost two thirds of expenditure here (**Figure 8**). Typical consulting projects have involved applying techniques developed in the private sector, such as work using lean manufacturing techniques to reduce the time take to process self-assessment forms at HM Revenue and Customs.[22]

[19] NAO estimates based on industry data
[20] NAO estimates based on industry data
[21] Author's estimates based on discussions with suppliers

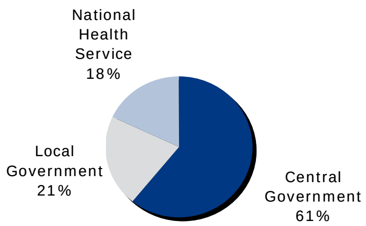
[22] *Ensuring sustainable value from consultants*

7. The breakdown of expenditure of consulting in 2005, private versus public sector

	Public sector			Private sector		
	Rank	£millions	Percentage of total expenditure	Rank	£millions	Percentage of total expenditure
Information Technology	1	1,031	36	2	1,592	26
Operations and process re-engineering	2	469	16	5	598	10
Programme/ Project Management	3	450	16	4	796	13
Strategy	4	294	10	6	393	6
Change Management	5	196	7	8	26	0.4
Human Resources	6	170	6	3	951	15
Outsourcing Consultancy	7	163	6	1	1,623	26
Financial Management	8	121	4	7	205	3
Economic and Environmental	9	4	0.1	9	4	0.1
Marketing and Corporate Communications	10	1	0.04	10	13	0.2
Total		2,897	100		6,201	100

Source: NAO estimates based on industry data

8. Breakdown of expenditure on operations and process re-engineering consulting in 2005

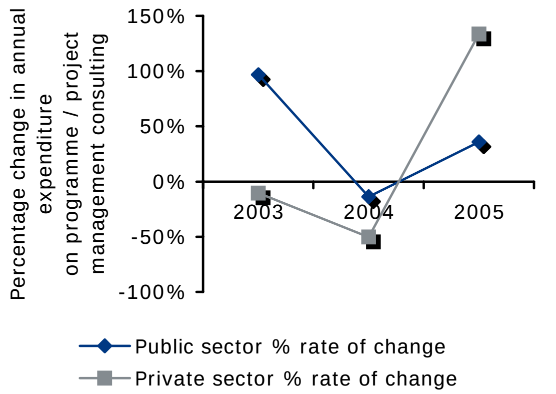


NAO estimates

- **Programme and project management:** The public sector spent £450 million on this type of consulting in 2005, up from £164 million in 2002. This is a similar proportion to that spent by the private sector (16 per cent to 13 per cent): in both cases, demand is largely tied into large-scale IT and outsourcing deals. However, demand in the public sector is slightly less volatile than that in the private sector (**Figure 9**), suggesting that there is a greater underlying need for these skills. This is borne out by other research: of the National Audit Office and Office of Government Commerce's "eight common causes of project failure", "lack of skills and proven approach to project and risk management" was a cause of concern for 71 per cent of Heads of Centres of Excellence. This was also an issue for Gateway reviewers, the "adequacy of skills and business resources" being identified as an increasing area of concern.[23]

[23] NAO, Delivering successful IT-enabled business change, HC 33-1, Session 2006-07

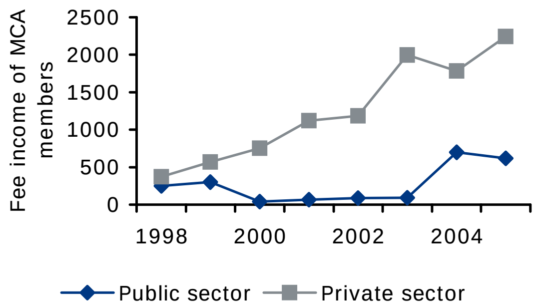
9. Comparing the annual percentage change in expenditure on programme and project management consulting in the public and private sectors, 2002-2005



Source: NAO estimates based on industry data

- **Outsourcing-related consulting:** The public sector spends substantially less in both absolute and relative terms on outsourcing-related consulting than the private sector – 6 per cent compared to 26 per cent in 2005[24] and the seventh most substantial area of expenditure compared to the most substantial area in the private sector. This is a reflection of the fact that outsourcing is less accepted as a management strategy in the public sector. In 2005, MCA member firms earned almost £4 from private sector outsourcing for every £1 they earned from public sector outsourcing (**Figure 10**).[25] This may, however, change in the future as the government pursues its shared services agenda. This strategy, combined with the greater reliance on outsourcing during times where cost reduction is high on the agenda may result in the same shift from consulting to outsourcing observed in the private sector in 2001-04 (see section 1).

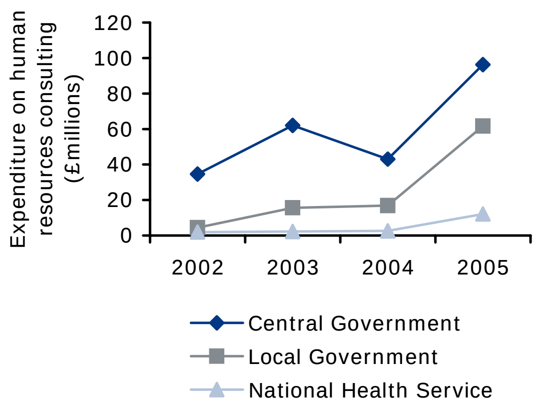
10. Comparing expenditure on outsourcing among MCA member firms, 1998-2005 £000s



Source: MCA

- **Human resources:** Expenditure on HR-related consulting rose steeply in central and local government in 2005 (by 123 per cent and 267 per cent respectively) (**Figure 11**). However, the public sector still spends substantially less than the private sector on HR-related consulting, £170 million (6 per cent of the total), compared to £951 million in the private sector (15 per cent of the total) in 2005.[26] The recent rise is likely to be connected to the government's agenda for improving public services: large-scale technology and operational improvement projects inevitably have an impact on organisational structures.

11. Growth in HR consulting in the public sector 2002-2005 £millions



Source: NAO estimates based on industry data

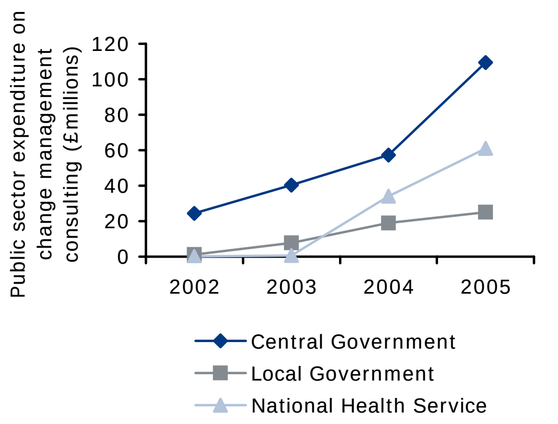
- **Change management:** Change management consulting involves a systematic approach to dealing with large-scale organisational and IT-related change. As the need to manage change rises in proportion to the size and complexity

[24] NAO estimates, based on industry data
[25] MCA

[26] NAO estimates based on industry data

of an organisation, it is perhaps not surprising that public sector spending on change management is higher than that in the private sector (7 per cent in 2005, compared to less than 1 per cent).[27] Given the impact of the Connecting for Health, spending on change management consulting has risen steeply in the NHS; however, spending in central government also rose sharply in 2005, a reflection of the complex technology projects underway (**Figure 12**).

12. Growth in change management consulting in the public sector 2002-05 £million



Source: NAO estimates based on industry data

Section 2: Challenges facing clients

10 The nature of consulting and its evolution create substantial challenges for managers who are seeking to hire or work with consultants, some of which are specific to the public sector.

Clients find it hard to understand what consultants do

11 The consulting process is notoriously difficult to describe in objective terms. There is wide variation in what people mean by the word "consultant", exacerbated by fact that many consulting firms also provide outsourcing and by clients' tendency to classify external input under different headings (consulting, contracting, interim management, etc). Moreover, the sheer variety of work undertaken by consultants makes it hard to generalise.

12 The situation has been exacerbated by consulting firms themselves who, by working in discrete teams, often away from a client's site, have made it harder for clients to understand what they do. As a result, consultants have been viewed as witchdoctors, fad-surfers or charlatans.[28] "All too often, [consultants] are know-it-alls with little useful experience or knowledge … But what they do know is how to make a good impression."[29]

13 In fact, the consulting industry exhibits the classic characteristics of information asymmetry, where one party to a transaction (the consulting firm) has more or better information than the other party (the client). Clients have typically found it hard to distinguish between consulting firms, validate the claims made by consulting firms in their marketing material and proposals and manage a consulting team effectively. A recent survey by the MCA, found that fewer than half of clients felt consulting firms provided adequate information about themselves, and 40 per cent thought firms could benefit from adhering to a common code of practice.[30]

14 The situation is exacerbated by the insecurity of managers who are attracted by ideas and techniques which "can convey the illusion of a predictable and certain world."[31] One of the ways consulting firms stimulate demand for their services is by taking new management ideas and techniques from organisation to organisation[32] but, in doing so, consultants also create further insecurity: "consultancy is fuelled by [consultants'] provision of a sense of reassurance to management and at the same time reinforcing or creating insecurities"[33] The public sector is as vulnerable to this as the private: "Politicians are no less addicted to [management] fads than their private sector equivalents – the only difference being that public sector fads seem to lag behind private sector fads by about five years."[34]

15 This imbalance of information has had profound implications. Clients' lack of information makes the consulting industry highly inefficient because it is hard for them to compare firms' proposals on a like-for-like basis or to get feedback on the performance of

[27] NAO estimates, based on industry data

[28] Eileen Shapiro et al, "Consulting: Has the Solution Become Part of the Problem?" *Sloan Management Review*, 1993
[29] Brian Bloch, "How they put the 'con' into consulting', *Managerial Auditing Journal*, 1999
[30] *Perceptions of Consultancy in 2005* (MCA, 2005)
[31] Andrzej A Huczynski, *Management Gurus* (Routledge, 1993)
[32] "Consultants mattered by extending the range of abilities and knowledge already available to … executives", McKenna, *The World's Newest Profession: Management Consulting in the Twentieth Century*
[33] Andrew Sturdy, "The Consultancy Process – An Insecure Business?", *Journal of Management Studies*, 1997
[34] John Micklethwait and Adrian Wooldridge, *The Witch Doctors: What the Management Gurus Are Saying, Why It Matters and How to Make Sense of It* (London, 1996)

a particular consulting firm elsewhere in the market. Yet, at the same time, the consulting industry relies on clients to "regulate" it. "Consultancies do not have to overcome a pre-entry quality threshold in order to operate in the industry. There is no minimum standard of quality that all consultancies are obliged to offer. Rather, the quality of a consultancy's service is something that clients have to determine when choosing between alternative suppliers of consultancy services."[35] Thus, it is theoretically possible for a poorly performing consulting firm to continue selling services to new clients in the confidence that its bad reputation would never catch up with it.

What I'd like, as a client is a better way to gain information about a consulting service without being bombarded by white papers and sales calls. Not only is there no way to find out about consulting companies who might have the precise skills we need, but there's also no way to get an independent, third-party review. If I was buying a car, I could buy a bunch of magazines carrying reviews of the model in which I'm interested, why can't I do that with consulting firm?[36]

Clients also find it hard to assess whether they are getting value for money

16 The difficulty clients have in understanding the scope of consulting is one of the reasons why they find it hard to measure the value added by consultants – something that is a source of frustration on all sides. But there are other factors at play here:

- **Reluctance to expose decisions and work to scrutiny.** Given that no one has to hire consultants, the responsibility for doing so largely rests with individual managers. Few managers like to have their decisions questioned or evaluated: not surprisingly, they have been reluctant to invest time in finding ways to measure consultants' input because the results of such studies may potentially show that they have not made effective use of consultants. Consultants, too, have been nervous about subjecting their work to scrutiny, concerned that any attempt to quantify their contribution on a systematic basis will inevitably under-value the less tangible aspects of their work and will be open to considerable misinterpretation.

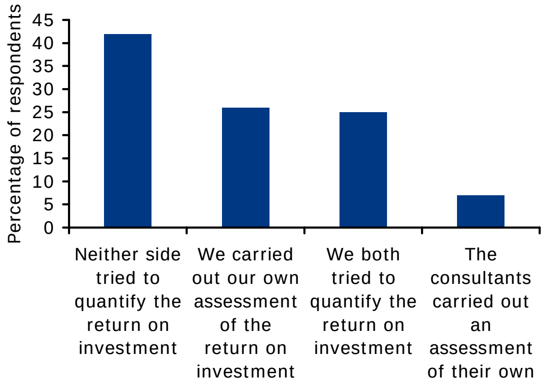
- The sheer range of consulting activity makes it difficult to identify meaningful metrics for all types of project. While some projects have clearly-defined outputs (a project to implement a new IT system can be evaluated in terms of its timely delivery, whether it kept within budget and/or the extent of take-up among users), many do not. How, for example, should a project aimed at improving the effectiveness of a management team be gauged? A solution has evaded even the academics specialising in this field. "Numerous variables affect … these [organisational] systems, and it is relatively difficult, and sometimes impossible, to isolate the specific effects of the consultancy process with the aid of just one measuring instrument. Moreover, even if this was possible, there remains the problem that the effects of consultancy are not always observable and therefore immediately measurable."[37] Not surprisingly, a third of clients agree with the statement "we need a methodology to help us quantify the benefits of consulting projects".[38]

- It is not always easy to attribute cause and effect, even where performance has improved. If a consulting firm has implemented a customer service system and customer satisfaction improves, it may be tempting to attribute the improvement to the system, but other variables may have changed (the recruitment of better customer service people, etc). Very rarely is it possible to point to isolate consultants input. However, the situation is made worse by the fact that 40 per cent of clients only assess the benefits of projects as a whole and do not capture or quantify the difference the consultants may have made (for example, completing a project more quickly than would have been possible if only in-house resources had been used).[39]

17 As a result, almost half of all organisations do not attempt to quantify the return on investment from using consultants (**Figure 13**).

[35] Timothy Clark, *Managing Consultants: Consultancy as the Management of Impressions* (Buckingham, 1995)
[36] Client quoted in *Consulting on the Brink: The Implications of Enron for the Consulting Industry* (London, 2002)
[37] Camal Gallouj, "Asymmetry of Information and the Service Relationship: Selection and Evaluation of the Service Provider", *International Journal of Service Industry Management*, 1997
[38] *Ensuring sustainable value from using consultants*
[39] *Ensuring sustainable value from using consultants*, MCA 2006

13. The impact of the difficulties in measuring the impact of consulting



Source: MCA 2006

Professional distance in the client-consultant relationship has become harder to maintain

18 One of the questions posed by Enron concerned the long-standing relationship between the company and its auditors. The fact that Arthur Andersen earned considerable consulting fees from Enron in addition to auditing its accounts suggests that "the consulting relationship of the accounting firm conflicted with their audit responsibilities to the Enron board."[40] Regulatory changes in the US (Sarbanes-Oxley) and client concerns in Europe have meant that the major accounting firms, while looking to grow their consulting practices, will be doing so among non-audit clients in order to ensure there is no conflict of interest.

19 There are, however, no restrictions on the amount or duration of consulting work done by consulting firms. This is largely because, unlike auditing, consulting does not follow a prescribed process. Indeed, the ability to adapt a standard process is often critical to the success of consulting projects.

20 The relationship between a client and a consultant is therefore a delicate balancing act:

- Independence and objectivity: Obtaining objective and/or independent advice is the second most important reason why organisations use consultants. Around a fifth of all consulting work is driven primarily by the need for this type of input.[41] Yet the increasingly blurred distinction between consultants' advisory and implementation / outsourcing work (see section 1) can compromise a firm's ability to provide this. If a consulting firm stands to earn substantial fees from implementing a specific software package (perhaps because it earns a commission from the software producer) or outsourcing a particular process, it is possible that any preliminary advice it gives a client may be influenced by what it stands to gain. "Cynics may find it intriguing that the same consulting groups that help make decisions on outsourcing just happen to have their own outsourcing business."[42] This will only be an issue for some consulting projects, however: where a consulting firm has, for instance, been hired to implement a particular software package, it can be advantageous to the client for the consulting firm to have close links with the software manufacturer. Growing awareness of this issue among clients has boosted the market for "client-side advisory" work and is contributing to the polarisation of the consulting industry (see section 1). Where independence is an issue, managers have to be clear about what they are buying, choosing – for example – to use two consulting firms, one to advise and one to implement.

- Ownership and accountability: Both clients and consultants can gain from long-term relationships. Clients have access to people who understand their business and who can work with them when required without an expensive learning curve. Consultants have a better sense of the potential work to be won and, because they are familiar with the client's organisation, believe they are more likely to win that work. Continuity also plays an important role in accountability: a consultant (or, for that matter, a client manager) who thinks they will only be involved in a project for a short period may have little incentive to work towards its long-term success. However, situations where consultants perform their role for long periods of time create dependency and blur accountability. In these circumstances, the consultants are more likely to be treated as substitute managers, doing their clients' work for them and de facto becoming responsible for the delivery of results. "It is necessary to draw a distinction between interim management or contracting, and management consulting. True consulting is about creating and implementing innovative solutions to challenging problems and opportunities. Management consultants'

[40] Ashish Nanda, "Broken Trust: The Role of Professionals in the Enron Debacle", Harvard Business School, 2002
[41] *Perceptions of Consultancy in 2005* (MCA, 2005)
[42] Barbara Quinn, Robert Cooke and Andrew Kris, *Shared Services: Mining for Corporate Gold* (London, 2000)

rates allow for the stop-start nature of the work and the need for investment in methodologies, research and support staff. Interim management and contracting is principally about resource augmentation. The lower unit rates reflect the longer, more continuous nature of this sort of work. The government sector propensity to focus on rates when hiring often leads to the selection of an interim manager or contractor to carry out a creative consulting assignment. The results are frequently sub-optimal."[43] Consultants who stay too long in any organisation risk "going native" because they become too enmeshed in the organisation's politics and decisions to be able to stand back as an outside observer. As a result, they may not be able to offer genuinely independent advice, their skills may become outdated and they may lose the momentum they might have been expected to add.

21 To counteract all of these pitfalls, some clients have opted to involve several suppliers in a single project. A prime example of this is in the public sector is the Connecting for Health programme where consortia of suppliers are responsible for delivering packages of work. According to Richard Granger at Connecting for Health, "where a client depends on just one supplier, the balance of power can shift substantially in the supplier's favour… We have to balance the carrot and the stick, offering the top-performing suppliers the chance to earn extra fees at the expense of the worst-performing ones."[44]

"Consultants goals are not necessarily your goals": [45]

22 Clients need to know that consultants are working in their (the clients') best interests, but consulting firms have their own commercial interests to serve as well. Indeed, with the exception of major strategy consultancies, most large and medium-sized consulting firms are now public companies with shareholders to satisfy. Both sides have sought to bring their interests into line by changing the way in which consulting firms are paid. Initially, this meant shifting from the traditional hourly or daily rates to fixing the price for a specific piece of work. More recently, it has taken the form of performance-related pay, where "success" is defined in terms either of an output from the project (the implementation of a new IT system on time) or a business "outcome". "Terms like 'strategic partnership' are inviting. What a strategic partnership means is debateable. Understandably, it is a noble and worthwhile aim to work with vendors who operate in a partnership spirit, but the idea of suppliers being true partners is not very practical unless there is a legal strategic partnership in place with mutual financial stakes and mutual interests on the table."[46] But "risk/reward" payment is still limited to a minority of consulting projects – around 12 per cent compared to 56 per cent where "time and materials" are used and 32 per cent fixed price.[47] One reason for the comparatively low take-up of contingent payment mechanisms is that they are only suitable for projects with a clear set of deliverables and/or outcomes, and not all consulting projects have this. However, lack of buyer experience and concerns over paying the consulting firms too much under such arrangements may also have inhibited their use. "Some companies have backed off because of the amount of money they … have ended up paying for a successful project; others have seen this fee structure didn't ensure better results".[48]

The operational model of consulting can frustrate clients

23 The archetypal consulting firm has a pyramid structure in which the expensive time of a small number of people at the apex of the pyramid is spread across a large number of projects which are run by experienced project managers and staffed with more junior, less experienced consultants. By this means, it becomes possible for a senior partner or director in a consulting firm to work on several projects at once.

24 The pyramid firm, and the concept of leverage that goes with it, were codified and popularised by David Maister whose book, Managing the Professional Services Firm, has become the blueprint for how most consulting firms have structured themselves. As Maister points out:

The successful leveraging of top professionals is at the heart of the success of the professional firm…. A significant proportion of partnership profits derive from the surplus generated from

[43] Interview with Alan Russell, head of consulting at LogicaCMG
[44] Quoted in Toppin and Czerniawska, *Business Consulting: A Guide to How it Works and How to Make it Work*
[45] Lee Kercher, Chief Network Officer, California State Department of Information Technology, quoted in Quinn et al, *Shared Services: Mining for Corporate Gold*
[46] Quinn et al, *Shared Services: Mining for Corporate Gold*
[47] *MCA Operational Benchmarking*, 2004-05
[48] Melissa Master, "The Party's Over", in *Across the Board*, 2001

hiring staff at a given salary and billing them at multiples of that salary. By leveraging its high-cost seniors with low-cost juniors, the professional firm can lower its effective hourly rate and thus reduce its costs to clients while simultaneously generating additional profit for the partners.[49]

25 The shape of the pyramid varies from firm to firm: some, typically strategy firms, may have a relatively small number of junior consultants per partner; others, more likely to be IT consulting firms will have a larger ratio of junior to senior staff. The exact ratio is determined by the homogeneity of the service being provided (standardised services require less senior input) and the management philosophy of the firm. However, as consulting firms have sought to keep costs low and remain price competitive, the average ratio of junior to senior staff has doubled from 13:1 in 2002 to 26:1 in 2005.[50]

26 The pyramid structure benefits clients in the form of lower average prices, but it has potential disadvantages:

- **What you see is not always what you get:** Leverage can mean clients get less input from the senior people whose time they may have thought they were buying. In this respect, the pyramid structure does not sit comfortably with clients' desire for specialist expertise. If half of all clients bring consultants in because they want access to specific skills not available in-house, then a business model that depends on providing junior, necessarily less knowledgeable people will inevitably breed dissatisfaction. "Too many sales pitches are still treated as show-cases, putting their best people on display who you know you will never see again."[51]
- **You don't always know what you're paying for:** Clients find it hard to understand how the bills they receive relate to time spent; a problem which is being exacerbated by the recent move towards "blended" daily rates (ie average across all grades of consultant). While being easier to administer, these make it harder to compare consulting firms for procurement purposes (it is less clear what is being sold) and to ensure that the desired and expected ratio of senior to junior people work on the project in practice.

27 Dealing with these issues requires an in-depth knowledge of the consulting industry and the operations of firms. Although such knowledge can be gained over time, through working repeatedly with consultants, many organisations exploited redundancies in the consulting industry in 2002 to 2004 to recruit ex-consultants, either to run consulting projects or to oversee their procurement.

Depressed demand and over-capacity on the supply side have given clients considerable negotiating power," commented the MCA in 2004. "Consultants, made redundant from their firms, have moved into positions as client managers and brought with them a more sophisticated understanding of the internal mechanics of the consulting industry.[52]

Section 3: Challenges facing consulting firms

Balancing supply and demand is almost impossible in a volatile market

28 Consulting firms, because their costs are people rather than capital-based, have historically considered themselves to be agile organisations. This belief was based on two assumptions: first that it was possible to predict trends in demand for consultancy; and, second, that changes in the market could be anticipated and accommodated by developing new services and retraining consultants. Both assumptions have proved wrong in practice.

29 Although detailed information on trends in the consulting industry has been available for only the last four years, the volatility of the market is still apparent. For example, demand for programme management (one of the largest consulting markets in the UK) fell by 37 per cent in 2004 only to double in size the following year. Conversely, demand for economic and environmental studies, which grew by more than 90 per cent in 2004, fell by a quarter in 2005.[53] Furthermore, research indicates that the life-cycle of a management tool or idea (so often a driver of demand for consulting) has become both sharper and shorter-lived,[54] probably as a result of the ease

[49] *Managing the Professional Services Firm*
[50] *MCA Industry Report 2005-06*
[51] Ahmad Abu El-Ata, interviewed in Toppin and Czerniawska, *Business Consulting: A Guide to How it Works and How to Make it Work*
[52] *MCA Industry Report 2004-05*
[53] NAO estimates based on industry data
[54] Paula Carson, Patricia Lanier, Kerry Carson and Brandi Guidry, "Clearing a Path Through the Management Fashion

with which information on them can now be disseminated. Consulting firms have therefore moved from an environment in which a new management tool might have a shelf life of 10 to 15 years to one in which a tool is likely to reach obsolescence in less than three years.

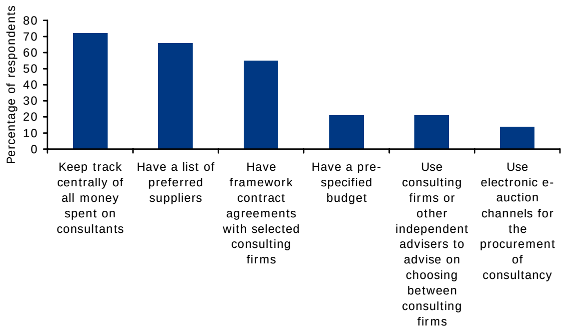
30 This situation has been exacerbated by the extent to which specialist skills has become an important driver of demand for consulting (see section 1) and by the growing sophistication of managers who have become less willing to tolerate what they see to be inexperienced consultants learning on the job (see section 2). With retraining existing staff less feasible, consulting firms have to recruit in some areas, while shedding staff in others. According to John Campagnino, Accenture's global head of recruitment, "the market is … much less predictable. When I started here … we planned our recruitment at the beginning of the year and spent the rest of the year implementing it. Today, we have to be far more nimble, hiring precisely defined skills on a rolling monthly basis."[55] However, fear of losing market share tempts firms to recruit in what they hope to be emerging markets, often paying over the odds for specialist skills. As David Barford, former head of Mercer Human Resource Consulting, put it: "There's a general tendency in the consulting industry to hire people ahead of the curve – firms rush into the market, pay high salaries and don't stop to think how these recruits will add value."[56] Salary inflation spirals even when prices remain depressed and puts margins under pressure.

The centralisation of procurement has changed the relationship between clients and consultants

31 Consulting is a relationship business: most work is won through networks of existing contacts, rather than through advertising or other sales promotions; on average, around 70 per cent of a firm's work is "repeat" business, ie sold to existing clients.[57]

32 To counter the imbalance of information between clients and consultants (see section 2), many organisations which spend a substantial amount of money on consultants have established more formalised and centralised procurement processes. A 2006 survey by the MCA indicated that more than 70 per cent of organisations spending in excess of £5 million a year on consulting tracked their expenditure centrally, and two thirds had lists of preferred suppliers (**Figure 14**).

14. Increasing formalisation of procurement in organisations which make substantial use of consultants



Source: MCA 2006

33 From the supply-side point of view, the result of these changes has been to keep prices comparatively low, even at a time when demand for consulting is growing. The average fee rate for a director or partner in 2005 was £1,625 and that for a consultant was £925, levels that have not significantly changed since the late 1990s.[58]

For an industry that's been almost exclusively relationship-based, these are potentially disruptive trends… Procurement departments are the new intermediaries. The smart ones understand how important it is for a consulting firm to develop the requirements for a project in close collaboration with a client. But many adopt a more transactional approach and focus on price at the exclusion of everything else.[59]

34 Consultants also believe procurement professionals are more likely to opt for conventional time-based fee structures because it is easier to compare firms and achieve discounts. Time and materials is the easiest mechanism, but it doesn't take into account the calibre of people being put forward. Moreover, if the procurement process drives down prices too far, then firms reach the point where they

Jungle: Some Preliminary Trailblazing", *Academy of Management Journal*, 2001

[55] Quoted in Fiona Czerniawska, *The Trusted Firm: How Consulting Firms Build Successful Client Relationships* (John Wiley, 2006)

[56] Quoted in *MCA Industry Report 2003-04*

[57] *MCA Operational Benchmarking*, 2004-05

[58] *Management Consultancy Fee Rate and Salary Survey 2005*, Management Consultancy Information Service 2006

[59] Victor Koss, Booz Allen & Hamilton, quoted in *The Trusted Firm*

cannot afford to put their best people on these projects.

35 However, perhaps the most significant impact of more formal procurement processes has been to limit the number of options that can be explored between clients and consultants both prior to and during the sales cycle. Such complaints are voiced especially loudly where the public sector is concerned, a problem exacerbated by the variety of framework agreements a consulting firm may have to tender for:

Winning work in the public sector has become a laborious process. On one occasion, we had to present twice and re-propose three times, and there was no sign that a better decision was made as a result. Even the civil servants involved were bored and complained about the time wasted. Instead of improving procurement, supposed reforms have turned what was a straightforward and robust system into a laborious process. If anything, they have weakened procurement discipline, not strengthened it.[60]

36 A consulting sale is essentially a consultative sale: the requirements need to be understood, debated and challenged by both client and supplier if a project is to be correctly scoped. The Office of Government Commerce already recommends that departments about to engage in large scale and/or complex IT projects debate the "concept viability" with selected suppliers. "Suppliers welcome the opportunity to meet with prospective customers and advise them on the "do-ability" of their idea and to discuss key issues related to potential solutions."[61] A similar approach for large-scale consulting projects would benefit both sides.

Increasing commoditisation threatens the consulting industry's reputation and profitability

37 At the heart of all this is the problem of commoditisation. While demand for consulting has increased, there has been no concurrent improvement in the reputation of consultants. Research by the MCA suggests that 98 per cent of clients are satisfied or partially satisfied with the work their consultants have done and 80 per cent would use the same firm again in the future.[62] Yet the reputation of the consulting industry, certainly as portrayed in the media, is largely negative. "Too often these consultants know too little about the delivery … to be trusted … More broadly, hiring them is too often a way of shelving a problem rather than solving it."[63]

38 Changes in the procurement process reinforce this perception: by being bought as a commodity, consultants become a commodity. The industry is therefore on the edge of being caught in a vicious circle. As the opportunity for consultants to talk to clients about their brief and to understand where they can add most value is squeezed by the procurement rules, the chances of being able to add value in practice diminish. Moreover, the focus on cost deflects the debate away from the value they can genuinely add: "When you hire a management consultant, the price may be a relevant issue from a cash standpoint, but the consultant who saves you five years of trial and error is worth a great deal of money."[64] As a result, certainly in the public sector, where the vast majority of scrutiny over expenditure on consultants has been focused, calling in consultants in the public sector is seen as failure: "The Government have been reaching for management consultants in a desperate bid to compensate for their management failures."[65]

39 The results of commoditisation show in firms' bottom lines: the average operating margin across the MCA member firms was 14 per cent in 2004, down 4 per cent on 2003.[66]

40 However, some of blame for the reputational damage incurred by the consulting industry in recent years has to be laid at the door of consulting firms themselves. The industry still has to lay to rest the ghost of the dotcom era which saw consulting firms putting rapid growth ahead of investment in new services. Because clients often find the structure and operations of consulting firms opaque, consultants face an uphill struggle explaining that there are many other costs which have to be covered by a consultant's daily fee-rate, that the money paid to consultants does not go

[60] James Morton, HTSPE, quoted in *MCA Industry Report 2005-06*
[61] Intellect, Senior IT Forum: http://www.intellectuk.org/markets/groups/senior_it_forum/concept_viability.asp. Intellect offers this as a free service to government departments
[62] *Perceptions of Consultancy in 2005* (MCA, 2005)
[63] The Times editorial, 30 May 2006
[64] A chief executive, quoted in Dannielle Nees and Larry Greiner, "Seeing Behind the Look-Alike Management Consultants", *American Management Association*
[65] Andrew Lansley, Shadow Health Secretary, quoted in The Times, 30 May 2006
[66] *MCA Operational Benchmarking*, 2004-05

directly into their pockets. Nor is there much money to invest: consulting firms now face competition from "offshore" suppliers – companies in low-cost economies offering outsourcing, IT development and, increasingly, consulting services at a much lower cost than their "on-shore" equivalents.

41 Consulting firms thus find themselves trapped between a rock and a hard place. Concerns over reputation, value and lack of innovation will only be countered with greater investment, and at a time when firms are already facing salary inflation as they compete for the best people. Yet those same issues – reputation, value and lack of innovation – make it hard for them to raise prices in order to cover their increased costs:

It puts pressure on the consulting firm: clients are expecting to pay the same, but our costs are rising, and it's getting harder and harder to find people we can afford to recruit. If rates don't rise soon, consulting industry margins are going to be under a lot of pressure.[67]

It all makes the internal model of a consulting firm very fragile.[68]

[67] Richard Budd, Marketing Director of LCP Consulting, quoted in the *MCA Industry Report 2005-06*

[68] Mark von Bergen, RSM Robson Rhodes, quoted in the *MCA Industry Report 2005-06*