

Service Leadership, Inc.

# Using the S-L Index™ Normalized Solution Provider Chart of Accounts

*Enabling the Measurement and Comparison of Profitability and  
Best Practices*

Service Leadership, Inc.

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## Why a Normalized Solution Provider Chart of Accounts™?

The Normalized Solution Provider (SP) Chart of Accounts (CoA) was created for two reasons. First, of course, we had to create it in order to deliver benchmarking results that are meaningful; to be able to compare apples to apples as much as possible.

More importantly, though, this CoA has been developed over twenty-five years of experience running Solution Provider businesses large and small, as well as diagnosing the financial and operational challenges of Solution Providers with whom we are working to improve their results or complete a merger and acquisition deal.

The Normalized SP CoA™ enables the effective management of a Solution Provider business by allowing managers to understand which parts of their business are producing profit, which are producing loss, and why. Only when this insight is available can managers take targeted action and measure the results.

In addition, of course, by applying a common, standardized approach to these measurements on an annual or quarterly basis, Solution Providers can objectively evaluate which practices produce best in class results – and thus truly are best practices – and result in a meaningful and sustained change for the better.

## Which Audience Are You?

This document is intended for use by two audiences:

- Those subscribing to the S-L Index™ Quarterly Peer Group Benchmarking Service, who will be using the Service Leadership IT Company Optimizer™ to input their data.
- Those who have purchased the S-L Index™ Comprehensive Diagnostics Report, who will be using the S-L Index™ Comprehensive Benchmark Survey to input their data.

Although the uses of these two reports are substantially different, the data entry is very similar. Where there are differences, they are called out. Where specific Chart of Accounts line items are identified, they pertain to the first input form, the IT Company Optimizer™.

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## Sorting Out the Revenue

Income statements start with revenue and that's where the normalized CoA starts. The ten categories or accounts into which the Solution Provider's revenue will be broken down are as follows:

1. Product Resale (HW/SW) Revenue
2. Software Licenses (Own) Revenue
3. Infrastructure – Technical Services Revenue
4. Infrastructure – Professional (Project) Services Revenue
5. Infrastructure – Managed Services Revenue
6. Infrastructure – Shared Infrastructure Services Revenue
7. Applications – Technical Services Revenue
8. Applications – Professional (Project) Services Revenue
9. Applications – Managed Services Revenue
10. Commissions & Agency Revenue

We'll get into what specific types of work go into each of these in a moment. First, though, it is important to understand why these specific categories were chosen, and not some others. There are two reasons, one of strategic importance and one tactical.

Strategically, these categories most clearly distinguish all the major services a given Solution Provider may offer, when doing a valuation or describing the business of the company to an outside investor who is not intimately familiar with our industry.

Simply put, if you can articulate the business of a Solution Provider in these terms, you can explain to a non-Solution Provider not only what they do, but also give a good idea of how they generate value.

Each of the ten categories generates value in a unique way, which is essential for an investor to understand. As it turns out, this makes the same ten categories an excellent way to measure the components of value in a given Solution Provider and compare them with those of other Solution Providers.

The critical tactical reason for choosing these ten categories comes from the opposite: How is work most effectively organized within a Solution Provider for profit and quality of delivery?

Running a product resale business is difficult, running a services business is hard work, and running them together is even more challenging. The least we can do to give ourselves a head start. So we organize the work in such a way that it is easiest to manage and measure.

As it happens, this means two things.

- First, separate product resale revenue and cost from those of the services. Now we can see how product and services are performing, without the one masking the results of the other, so we can more effectively manage both for profit, separately and together.
- Second, separate the services into the most manageable chunks. In the IT services business, if you are running it for profit, the most straightforward way to do this is to separate them by their billable utilization patterns. To make good profit, service managers (and those selling services) must architect their service offerings (value proposition, pricing, contracting and delivery) to maximize the billable utilization of the service people who make up the largest component of cost in the company.

Only by dividing the services business into its constituent utilization types, can a management team effectively manage each of those types to their optimum price/cost ratio. Mixing services with different utilization patterns means not being able to measure each of them against its optimum goal. This in turn means they're much harder to manage, and it also means you can't very well provide incentive pay based on reaching the correct utilization goals and behavior.

Those of you who have been implementing Managed Services know this first hand – you are trying to get a team of “hybrid” engineers to correctly utilize their time when serving both T&M customers and Managed Services customers.

Ironically, the Solution Providers who have the easiest time at this “new” hybrid model are those who started way back in the 1970's and 1980's, when the predominant forms of service were non-contract break/fix (T&M) and hardware maintenance contracts (the first form of true flat fee Managed Services).

They long ago instilled in their value propositions, their contracts, their people, metrics and management, the value differences between driving high utilization (good gross margin on T&M customers) and driving low utilization (good gross margin on maintenance contract customers). Even to this day, the few who remain doing a large proportion of traditional maintenance contracts often make good or very good money doing so.

For these critical operational reasons, the Normalized SP CoA™ breaks services revenue down into chunks determined by the major utilization types. Optimizing the utilization behaviors – and so the gross margins – of these different chunks demands different management techniques for each. This is why they often evolve into separate practices within the Solution Provider.

Different service managers even migrate to given practices based on their personalities and personal preferences for managing certain types of work (utilization). Happily, applying the normalized CoA then gives you a way to measure the gross margin (and possibly operating profit) performance of the each of the managers within these practices.

Now we have a closed loop between the strategic value generation capability of the company and the daily operational responsibilities of the managers and people within each practice.

Now let's look at the ten revenue accounts and understand what goes into them.

## The Ten Revenue Accounts

We earlier saw the ten revenue accounts:

1. Product Resale (HW/SW) Revenue
2. Software Licenses (Own) Revenue
3. Infrastructure – Technical Services Revenue
4. Infrastructure – Professional (Project) Services Revenue
5. Infrastructure – Managed Services Revenue
6. Infrastructure – Shared Infrastructure Services Revenue
7. Applications – Technical Services Revenue
8. Applications – Professional (Project) Services Revenue
9. Applications – Managed Services Revenue
10. Commissions & Agency Revenue

Let's take them one by one.

### Product Resale Revenue

Product resale revenue is categorized by itself because of the specific way it generates gross margin: you buy things from their makers (or distributors) and you resell them, hopefully for a higher price.

Because the traditional structure and habits of IT Solution industry work against delivering value in this scenario, the gross margin you can win for this service is low. As a result, the various overhead cost ratios (sales and marketing, administrative and so on) must be kept very low.

When product resale revenue is a meaningful component of the business model (say, 30% of total revenue or more), success requires specific operating techniques which require close measurement of costs and prices. When product resale revenue becomes the major component of the business model (say, 60% of total revenue or more), cultural patterns emerge which make more difficult the operation of a successful services business (even when services generates the lion's share of the gross margin dollars, the preponderance of product revenue drives the cultural model).

Conversely, when the primary revenue (not just gross margin) generator is services, it's helpful to separate product resale revenue so the services lines of business can be more effectively measured and managed.

The types of products which belong in this category are those which are bought and resold on a one time, though possibly periodically repeated, basis (as opposed to scheduled, recurring revenue, which we'll come to later). These include:

- Hardware,
- Software (that you didn't write),
- The "packaged" services of others, such as vendors' maintenance contracts,
- The "real" services of others where you don't manage the people doing the work (i.e. when they're not contractors under your direction),
- The "real" centralized services of others, such as white-label or branded help desk, back-up, network monitoring and management, etc.

This last sub-category – re-sold centralized services, especially the white-label ones – will probably cause some concern. After all, if you chose to deliver these services with your people, the revenue wouldn't go into product resale, so why would simply outsourcing that back end cause this revenue to be included in "product resale"?

The answer is, because it has a pre-determined gross margin, which is unaffected by your efficiency and effectiveness of delivery. When the only influence you have on gross margin is the spread between your selling price and your discount level, it's a product. Whether it comes in a box or not is immaterial: the economics and management techniques are more similar than different, so these re-sold services are all categorized as product resale.

This may also cause some revenue reporting challenges. Today you may bundle your own services and other's white-label services together into a single Managed Services fee, and do the same with their associated Costs of Goods Sold (COGS). However, taking the trouble to sort these out into their proper categories will provide you with clear benefits in terms of managing for profit.

A few quick notes which apply if you are doing the S-L Index™ Comprehensive Survey (and not doing the S-L Index™ Quarterly Peer Group Benchmark):

- Annual software maintenance fees that you charge to customers and pass on a portion to the software vendors, should be included in product resale.
- Materials and supplies used for cabling projects should also be included in product resale.

If instead you are doing the S-L Index™ Quarterly Peer Group Benchmark, there are separate categories for these, clearly labeled as such.

## Software Licenses (Own) Revenue

This section is designed to capture revenue from packaged (commercial) software that you have built/developed/published or that you have exclusive rights to. Do not enter revenue from building customer applications for clients: that revenue stream will be reported under the Applications Practice sections.

Do include both the revenue from the license sales of software you have built/developed/published as well as any maintenance revenue you receive from clients to maintain this software.

If you do not build/develop/publish software which you then sell to clients you have no revenue to report in this section.

## Services Revenue Overview

Keeping in mind our goal of providing line and senior managers with the ability to measure, motivate and manage profit by practice, Infrastructure services and Applications services must be tracked separately. Strategically, these two practices also deliver different value propositions.

There's no need to spend time here discussing the legendary differences between managing application developers and their utilization peculiarities and managing infrastructure engineers and theirs. They almost always must be managed as separate teams or practices and hence here we will categorize them separately.

However, it is helpful to explain why certain other clearly distinguishable practices are not separated out into their own categories within the normalized CoA. The ones that first come to mind are:

- Cabling and other low voltage electrical work,
- Traditional telephony (POTS/PBX as opposed to VoIP/IPT/UC),
- Various forms of customer technical training,
- System rentals,
- Presentation and boardroom systems.

And there are others.

We'll show you how to capture these within the benchmarks shortly, but why didn't we create separate categories for these clearly distinct practices? The answer is, for the vast majority of Solution Providers, the ten main categories represent the majority of their revenue and profit sources. Simply put, these

additional potential practices are either not offered by many Solution Providers, or they're not material enough to merit a change in how they're managed and measured.

Given this, we had to make a judgment as to the ultimate complexity of the CoA and the resulting benchmarking process. Balancing ease of use with materiality made it clear that these less common, often much smaller lines of business would be incorporated into the more material lines of business. After all, this is most likely how they are managed within the Solution Provider as well.

That said, we are aware from long experience that some lines of business which may not be material today can represent good profit growth opportunities in the future. We are constantly reviewing benchmark results, Solution Provider feedback, and income statements from Solution Providers we work with in our consulting and M&A practices, to keep an eye on which of these lines of business might be elevated to CoA status. Let's put it this way: being in the M&A business as we are, if you have a line of business that generates material value, we certainly want to be able to identify and evaluate it. For that reason, the CoA will be evolved on a careful, periodic basis.

## Infrastructure Practice

Services related to designing, installing and supporting the client's infrastructure are included in this category.

As noted above, these are:

- Infrastructure – Technical Services revenue
- Infrastructure – Professional (Project) Services revenue
- Infrastructure – Managed Services revenue
- Infrastructure – Shared Infrastructure Services revenue

In this section, we'll define what goes into each one, and give some examples of what's included and what's excluded.

### Infrastructure – Technical Services

These are services which are performed on a time and materials – or block time – basis and are not subject to a scope of work (which would instead be placed in Professional (Project) Services).

In many cases, this is ad hoc T&M support (also known as Break/Fix), performed on a reactive or mildly proactive basis. In fact, these services resemble in many ways the portion of Managed Services which focuses on remediation of problems. However, since this work is performed on a T&M basis, and not on flat fee, it is categorized here instead of in Managed Services.

Block time support is included here – even if it is pre-scheduled and recurring – because block time is by definition time and materials work, and therefore is not subject to the economies of scale available to flat fee Managed Services work.

Also included in Infrastructure – Technical Services are:

- Staff augmentation (for infrastructure only)
- Training of client IT staff on infrastructure skills or end users on “office” applications
- Any other labor-based time and materials revenue associated with Infrastructure support

A note: spare parts for maintenance contracts are included in product resale revenue.

Ad hoc time and materials work, to be profitable, has to be managed in a fashion similar to air traffic control in the air transportation business – every single minute incurs cost and therefore has to be managed for revenue maximization. Utilization can assume a scattershot pattern and effective management requires taking into account factors such as response times, response-tiered rates, skills-based task assignments, travel time and charges and their relationship to targeted and non-targeted geographies, dispatch and problem management methodologies, and so on.

In fact, these aspects of managing this line of business are closely akin to the yield management techniques used in the airline, hotel and rental car firm industries: there is a reason the yield-management departments of companies in those industries hire PhDs. Taking a cue from them: all of your thinking around services pricing and packing, work organization and compensation plans must have as its first priority, maximizing billable utilization.

### **Infrastructure – Professional (Project) Services**

In this category, include all T&M and flat fee work expended on projects with a scope of work. Projects have a unique utilization pattern: short duration, high skill phases such as planning, kickoff and design, followed by longer duration, higher volume consumption of lower skills during implementation, followed then by more short duration, high skill activities such as testing, documentation finalization, turn over and project closure.

Arguably, projects sold on a flat fee basis merit their own category. After all, we categorize flat fee support services as Managed Services to distinguish them from T&M support services, so why not have a separate category for projects done on flat fee, where (like Managed Services) good management can drive up gross margins significantly over the T&M alternative. Once again, materiality comes into play. Only a minority of Solution Providers consistently do projects on a flat fee basis, although those who do generally post higher gross margins on their projects than do their T&M-centric colleagues. Until more SPs develop the sales and service maturity to safely switch to flat fee projects, the added complexity within the CoA is not worth giving flat fee projects their own category.

Regardless of whether T&M or flat fee, the critical success factors associated with highly profitable project practices are: client expectation management, scope management, project management, allocation of sub-tasks balancing slower, lower cost resources with faster completion by more costly skills, effective use of pre-installation testing and documentation, product configuration and staging, and especially change order discipline.

In much the same way that moving to flat fee ups the ante on skills and methods initially deployed with less discipline when doing time and materials work, doing flat fee projects simply involves applying all the disciplines in the paragraph above with a greater degree of consistency and care. The easiest (though not easy) way to do this is to initially limit flat fee work to those solutions which the organization knows very well.

In addition, successful flat fee project firms also regularly charge 10% to 20% more for a given project than their T&M colleagues. Combined with the fact that their hourly rates are no longer published to the client (and therefore not directly subject to competitive comparison) and their generally better change order discipline, flat fee project firms stand a stronger chance of attaining higher gross margins, and often do. Given that customers presented with a T&M project agreement often choose, after the fact, to convince themselves they signed a flat fee deal, these methods are perhaps less of a leap than they may first seem.

### **Infrastructure – Managed Services**

The services that can be put into this category are those support (operational vs. project) services which are billed on a scalable flat fee and are governed by a service level agreement (SLA).

The “scalable flat fee” means per user, per device and so on, though it could also simply be a flat fee for the customer’s current configuration (assuming of course that some mechanism is in place other than hourly to raise the fee when the client expands).

By defining Managed Services this way, we are now able to measure our effectiveness at driving results within the line of business that is the most capable of delivering high margins and scalable revenues.

If you have a “hybrid” Managed Services model, where some of the services are T&M, then that portion of the work belongs in Infrastructure – Technical Services. This means, of course, that what was formerly lumped into Managed Services revenue may have to be split out. Also when we get to COGS later in this document, the cost of some billable people may have to be split between the two categories. While this may create reporting challenges for some firms, it does serve to accurately place these two types of services into the proper categories for effective daily operational management.

Similarly, the portion of Managed Services revenue that is served by “back end” white label or branded providers should be allocated to Product Resale revenue, as previously noted.

### Infrastructure – Shared Infrastructure Managed Services

In this category, we include revenue from those services which are delivered from IT infrastructure that you own – meaning your data center or any similar facility which you share across multiple customers.

This does not include a specific type of shared facility – your Network Operations Center (NOC). Revenues associated with this should be categorized in Infrastructure – Managed Services, above. This also applies to a centralized Help Desk (HD) that you operate. Although these are indeed services delivered to multiple customers and therefore a shared use of NOC and HD infrastructure, the infrastructure is used in support of Managed Services, and the bulk of the cost is the people who staff the NOC and HD. Therefore, this specific shared infrastructure should be categorized in Managed Services.

In contrast, when you build a data center or similar operation, the primary offering is to enable customers to use that infrastructure on a fractional basis, and the cost of your personnel to run it is probably not the largest portion of cost.

Falling into this category are the facilities you build to provide hosting, co-location, data center, remote backup, disaster recovery, virtualization and so on.

To the degree you are yourself using a third party to host equipment you own and then share out to multiple customers, that revenue goes here and the cost goes into the associated cost category, as will be discussed below.

### Applications Practice

In this section you'll report the revenues for those services which are related to: developing custom applications; installation, customization and configuration of line of business packaged applications (such as accounting systems); software-as-a-service sharing an application you wrote (or own) to customers from your center.

Each of these offerings represents a distinct value to the customer and exhibits different utilization and profit/loss characteristics, and thus requires different management techniques. From an operational management standpoint, they're likely to be separated into discrete practices as the organization grows.

To be sure, these three Applications categories could be divided further: for example, there are also differences between database programmers and user interface programmers, and differences between business intelligence practices and web presence practices.

However, as with the Infrastructure practices above, we must make a choice between extra specificity and practical usability. And we have segmented the Applications categories much as we have the Infrastructure categories, resulting in the following entries:

- Applications – Technical Services revenue

- Applications – Professional (Project) Services revenue
- Applications – Managed Services revenue

While much of the same rationale for the segmentation of Infrastructure Services applies to the same categories for Application Services, we provide some additional details on each Application Services category below.

### **Applications – Technical Services**

Like its counterpart in the Infrastructure side of the house, Applications – Technical Services includes revenue for those services which are provided on a T&M basis and are not part of a scope of work (i.e. not a project). This includes:

- Application staff augmentation,
- Training of client IT staff or end users on custom applications or line of business packaged applications (such as accounting systems),
- Ad hoc writing of software documentation,
- Ad hoc custom programming (minor code modifications)
- Ad hoc software testing.

### **Applications – Professional (Project) Services**

Like its counterpart in the Infrastructure side of the house, Applications – Professional (Project) Services includes revenue for those services representing all T&M and flat fee work expended on projects with a scope of work. Projects have a unique utilization pattern: short duration, high skill phases such as planning, kickoff and design, followed by longer duration, higher volume consumption of lower skills during implementation, followed then by more short duration, high skill activities such as testing, documentation finalization, turn over and project closure.

The revenues included in this section include:

- Application development, the design and build of custom applications for clients,
- Services related to configuring, customizing, modifying and installing packaged applications,
- Any Application Professional Services revenue not included above.

### **Applications – Managed Services**

The services in this section are related to provisioning your own applications on an ASP basis, or SLA-based services related to keeping your customer's applications running properly. These include:

- Application Service Provider (ASP) revenue from your own ASP'd applications. (Note: Resale of someone else's ASP application or service should be included under Product Resale Revenue, not in this section),

- Services related to the ongoing monitoring and management of the customer's applications,
- Services related to performing ongoing database administration,
- Any Application Managed Services Revenue not included above.

## Commissions and Agency Revenue

The revenues to be recorded in this section are related to fees and commissions you receive from third party vendors providing products or services to your clients. The key characteristics of these revenue streams are:

- The third party provider provides the product or service directly to the end customer
- The third party provider invoices the client directly for these products or services
- Your company never takes title to any of these products or services, and as such never records a Cost of Goods Sold (COGS) for their delivery
- Your company receives a commission or agency fee from the third party provider as compensation for connecting your client to their offering.

Examples of these revenues include the following:

- You introduce your client to a third party ISP provider; your client signs up for the ISP service directly with the third party provider, who in turns bills you client directly. The third party provider sends you an agency fee for having the client sign up for their service
- You turn to a product manufacturer to provide products to your client. The manufacturer ships the product to you client and invoices the client directly. The manufacturer then sends you a commission for the product sale.

Typically you will have no Cost of Goods Sold associated with these revenues. In some instances companies have an administrator who spends some of their time tracking and managing receipt of all commission and agency fee payments. In these cases you can record the cost of that person's time in the COGS section associated with Commissions and Agency COGS.

## Cost of Goods Sold (COGS)

While Solution Providers track revenues in a variety of ways, the ways in which they capture COGS is even more varied and inconsistent. Just as we have seen with recording revenue, it is important to take a methodical and consistent approach to capturing the expenses that go into the Cost of Goods Sold. It is also important to track COGS separately for each significant Line of Business (LoB) your company offers. Doing so enables you to see the specific gross margin percentage each LoB is achieving, enabling you to make the proper strategic and tactical decisions to enhance your business' profitability.

Consider the two examples illustrated below:

<b>Example A</b>	Revenue	COGS	GM\$	GM%
Product	\$ 1,256,888	\$ 1,103,548	\$ 153,340	12.2%
Services	\$ 2,239,236	\$ 1,374,593	\$ 864,643	38.6%
Company Total	\$ 3,496,124	\$ 2,478,140	\$ 1,017,984	29.1%

<b>Example B</b>	Revenue	COGS	GM\$	GM%
Product	\$ 1,256,888	\$ 1,103,548	\$ 153,340	12.2%
Services				
Technical Services	\$ 562,447	\$ 460,082	\$ 102,365	18.2%
Project Services	\$ 726,945	\$ 452,887	\$ 274,058	37.7%
Managed Services	\$ 949,844	\$ 461,624	\$ 488,220	51.4%
Total Services	\$ 2,239,236	\$ 1,374,593	\$ 864,643	38.6%
Company Total	\$ 3,496,124	\$ 2,478,140	\$ 1,017,984	29.1%

In Example A, all services revenues are aggregated as are all services COGS. Overall services gross margin percentage is 38.6%. Is this good or bad performance? What needs to be done to improve the overall services performance? In this example it is almost impossible to tell.

In Example B, the services revenues have been split into each significant LoB; seeing this detail presents a pretty clear picture. Technical services are a clear underperformer at 18.2% gross margin; project services are performing better at 37.7%, but there is still clear room for improvement; Managed Services are the star of the group, delivering a gross margin of 51.4%.

It is clear to see that Example B provides executives with more data relevant to making appropriate decisions about how each LoB is performing, where to make changes, where to make investments. The COGS entries available to you in the IT Company Optimizer™ will enable you to have this critical view of how each LoB is performing.

### Product Resale (HW/SW) COGS

The COGS entries for Product Resale are straightforward:

- Hardware COGS: the price you paid to the manufacturer for any products you have resold
- Software COGS: the price you paid to the software vendor for any software you have resold
- The COGS for “packaged” services of others, such as vendors’ maintenance contracts
- The COGS for “real” services of others where you don’t manage the people doing the work (i.e. when they’re not contractors under your direction)
- The COGS for “real” centralized services of others, such as white-label or branded help desk, back-up, network monitoring and management, etc.

## Services COGS

We have seen that Services Revenues are divided into two main categories: Infrastructure Practice and Application Practice. Each of these two main practice areas has subcategories (Infrastructure Practice has 4 subcategories, Application Practice has 3). The methodology for COGS data capture is exactly the same for all 7 of these Services subcategories, and consists of the following three items:

1. Hard COGS
2. Direct Labor W2 COGS
3. 1099 (Contractor) COGS

Let's examine each of these separately.

### Hard COGS

Hard COGS consists of any expense you incur *other than labor* to deliver the given service. Hard COGS examples include:

- Having to pay for a part to deliver the service,
- The cost of laptops and cell phones provided to technical personnel who are providing delivery of the service,
- The out of pocket expense you incur for providing training to technical personnel,
- Non-reimbursed travel expenses you incur as part of delivering the service.

### Direct Labor W2 COGS

This COGS line item is designed to capture the W2 expense (salary plus bonus plus any commissions) of the technical professionals employed by your company that are providing delivery of the service *plus*:

- An allocation for employee benefits
- An allocation for payroll taxes.

In fact wherever you are asked to input W2 expense (not just in the COGS section) you should also add to that the cost of that person(s) employee benefits and the amount you pay for that person(s) payroll taxes.

### 1099 COGS

This COGS line item captures the expense you pay to subcontractors (1099 workers, i.e., non-employees) to provide delivery of the service.

Using these three categories for capturing service COGS enables simplicity, accuracy and consistency across all Solution Provider's Chart of Accounts.

A common question arises when one or more of a Solution Provider's technical professionals support more than one LoB: how to best allocate the cost of that professional against multiple LoB's?

If you have a system in place that tracks a given professional's time against each discrete LoB you're all set: simply put that cost (plus an allocation for employee benefits and payroll taxes) into the COGS field for each respective LoB that s/he supports.

However, if you are like most Solution Providers, you don't have a system in place that automatically assigns a given professional's cost to each LoB they perform work for in a given quarter. That being the case, the recommended approach is to review the last quarter's time cards for all technical professionals and arrive at a percentage of total time that was spent delivering service for each of your LoB's. You can then use this allocation key for the next few quarters unless you experience a significant shift in the percentage of revenue coming from a given LoB: in that case you should review the past quarter's time cards once again to arrive at a revised allocation key. In any event the time card review should be performed at least once a year.<sup>1</sup>

If the professionals that provide service delivery against multiple LoB's have a wide range of total compensation then you will be best served by determining the time allocation by LoB for each professional and multiplying the resultant percentages against that specific professional's cost. Then add the costs of each professional for each LoB (don't forget to add an allocation for employee benefits and payroll taxes in each case) to arrive at total COGS for each LoB.

Once you have entered your COGS, the IT Company Optimizer™ will automatically calculate the Gross Margins for each LoB that you have entered revenue and COGS.

## Expenses (Selling, General & Administrative)

This section captures all of your operating expenses otherwise known as Selling, General and Administrative expenses (SG&A). Deducting these total expenses from your Gross Margin dollars produces your Net Operating Income (NOI).

You will see that in the IT Company Optimizer™ there are a total of 10 possible entries for operating expenses (E1 through E10). Undoubtedly your company's Chart of Accounts has more discrete line items on which to record operating expenses than are made available here. Not to worry: simply map your expenses where possible to E1 through E9, and then aggregate all other expenses and enter them into "E10 – All Other Operating Expenses".

A quick note of reference on a couple of these operating expense entries:

- E1 – Sales Department Compensation Expense: This line item is for compensation expense only for all sales and marketing personnel. It should include inside/outside sales, order entry, marketing personnel, sales management, etc. If the owner spends 75% of their time running the

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<sup>1</sup> Many PSA (professional services automation) tools allow you to set up reports which can perform this allocation monthly for you, which you can then easily interpret to allocate COGS by LoB.

business and 25% of their time managing sales then 25% of the owner's compensation should be recorded here in E1. Remember that here, and anywhere you are entering W2 data, you need to include an allocation for employee benefits and payroll taxes.

- E2 – Administrative, Management and Executive Compensation Expense: This line item is for compensation expense only, and should capture all personnel who are not in either service delivery or sales/marketing. If the owner spends 75% of their time running the business and 25% of their time managing sales then 75% of the owner's compensation should be recorded here in E2.

## People and Organization

This section is designed to capture the headcount totals by function for the past quarter. When entering data here decimal points can be used to reflect fractional full time equivalents (FTE's) that performed a given role for the quarter. For example you could record 3.75 for "O10 – Number of Technical Professionals".

This section is broken into three main categories: Sales Organization; Service Organization; and Administrative Organization. Each section merits a comment or two for background and clarification for data entry.

### Sales Organization

The following definitions should be applied when categorizing sales headcount. It is important to be intellectually honest about your categorization; please follow these definitions strictly.

- O1 – "Hunter" Sales Reps: a Hunter is one who worked to convert prospects into clients, then turns those new clients over to someone else to manage while the Hunter goes on chasing additional prospects. Hunters do not stay involved with the account after the prospect is converted into a customer, even for repeat sales or renewals.
- O2 – "Farmer" Sales Reps: the Farmer is the inverse of the Hunter; s/he only works with existing clients, trying to maximize their contribution to the firm through repeat sales and renewals, and never works with prospects.
- O3 – Hybrid Hunter/Farmer Sales Rep: self evident, and where most often the sales headcount from Solution Providers is recorded.
- If the owner spends 75% of their time running the business and 25% of their time managing sales then 0.25 should be entered in "O8 – Sales & Marketing Managers and Executives".

### Service Organization

In the COGS section, technical professionals' time was used to properly map labor costs to services LoB revenues. It is important to continue that same consistency when assigning headcount FTEs to each respective LoB here.

For those companies that have technical staff that is completely dedicated to a single LoB the process is simple: just enter the number of technical professionals in the team for each LoB and you are done. For most of us (those that have technical professionals supporting more than one LoB) the process isn't that simple.

A good methodology is to review how technical professional costs were mapped to LoB COGS, then use that as the baseline for determining headcount totals to assign to each LoB in this section. The outcome should be a strong and visible parallel for a given LoB between revenue, COGS and headcount entries. Many of the headcount entries are used to generate ratios measuring productivity and effectiveness by role/function. Inaccurate headcount entries can result in ratios that range from dismal to spectacular, but in either case will not be helpful to you in driving your business to the next level...so use care when calculating your FTEs here.

### Administration Organization

This section captures headcount for all non-sales, non-service delivery personnel. Remember to be consistent with how you have recorded compensation and how you record headcount: if the owner spends 75% of his or her time running the business and 25% of their time managing sales then 0.75 should be recorded in "O34 – Number of C-Level Executives".

### Principals' Compensation

This section is designed to capture information on compensation for principals and how they spend their actual time.

**IMPORTANT NOTE:** This section is independent from everything that preceded it. It is used to calculate Adjusted EBITDA in the quarterly S-L Index™ Report. What is important to understand is that when you enter principal compensation information into this section you are *not* double counting: the compensation information you entered in the sections above for principals (whether in Service Delivery COGS, Sales Management, or General Management expense) is correct and should not be altered even though you are now entering principal compensation again in this section.

A few of the line items in this section call for additional comment:

- **PC1** - Enter the number of principals who are actively involved in running the business. If a principal is working part time, use the decimal place to reflect the portion of time spent working for that principal (if no principal is active in the business enter 0). The number you enter will be multiplied against fair market value compensation (as determined by S-L's Annual Compensation Benchmark) for companies of your size and number of principals.

*The objective here is to identify the number of Principals that are actively involved in running the business. S-L will use this number to identify the fair market compensation per Principal for companies of your total revenue size and Predominant Business Model, and multiply that compensation per Principal against the number you enter here to determine the amount of Principal compensation expense that should be reflected in your Income Statement. This in turn*

*will be compared to what is actually reflected in your Income Statement (combined PC2 and PC3), and any difference will be added or subtracted from EBITDA to arrive at Adjusted EBITDA.*

- **PC2** - Enter the total reportable Wages compensation paid to all company principals (whether active or not in the business) for the past quarter. (Reportable" as in government wage reporting forms W-2 in the US; T4 in Canada; P60 in the UK; etc.).

*List here any salary, commissions and bonus paid to all Principals whether or not they are active in the business for the past quarter. So it is possible that a company may have 2 Principals, one of whom is active in the business and one of whom is not; if that is the case, your entry in PC1 above would be "1.0". However here you will want to reflect compensation for both Principals, not just those that are active in the business. You should include an allocation for employee benefits and for payroll taxes when you enter your data here. Do not include any distributions paid to Principals from the Balance Sheet; include only compensation paid to Principals that is reflected in your Income Statement*

- **PC3** - Enter the total "excess owner compensation" which are expenses incurred by the company that accrue to the benefit of the owner(s) for all principals (whether active or not in the business) for the past quarter. Do not include distributions from the Balance Sheet. Include only those expenses reflected on the Income Statement that are considered "owner only" expenses (above what non-owner employees receive; e.g. life insurance premiums, auto expenses above what employees receive, etc.).

*List here any expenses that are reflected in your Income Statement that are associated with the Principals (active or not in the business) that are above and beyond expenses that regular employees (non-Principals) incur. Examples include: life insurance premiums paid by the company for Principals; auto expense for Principals (above and beyond what is paid to other employees for auto expense); rent that is being paid above fair market rental rates if the company owns the building; etc.. The amount you enter here will be added to PC2 to arrive at "PC4: Total Principal(s) Compensation for the Past Quarter".*

## Leveraging the Normalized Solution Provider Chart of Accounts™

By now you have realized that this Chart of Accounts is not only the way to ensure that S-L Index™ participants input comparable results, but is an excellent Chart of Accounts with which to run a Solution Provider business. So structured, you can use your new Chart of Accounts in valuable ways:

1. Deliver actionable gross margin and sales cost reporting to best manage the business based on trailing results.
2. Used as budget categories, this CoA enables you to set budgets for all of your revenue- and cost-generating activities or departments, enabling better forecasting.
3. When items 1 and 2 are implemented together, you can produce budget vs. actual reports which are easy to analyze, enabling quick response to developing situations.

4. On the service side, the revenue and gross margin numbers can be quickly equated to proper billable headcount levels; likewise they can be quickly equated to proper sales headcount levels.
5. Once you have item 3 completed, you can set management incentive plans based on actual vs. budget performance on a quarterly or annual basis. This is the most sophisticated form of management compensation; it is the one most likely to produce management behavior which results in attaining company goals, and it also most closely aligns management compensation with shareholder returns.

However, a warning: it requires a high level of competency in setting budgets and tracking actual. While we recommend doing budget vs. actual reporting from the time you start using this Chart of Accounts, we'd suggest not moving management incentive compensation to this basis until your budget vs. actual performance is tolerably predictable and the reporting process is streamlined to minimize administrative labor.

6. This Chart of Accounts provides a clear illumination of the business for those who might provide capital to your business, or for potential buyers. This is generally a positive differentiator since many Solution Providers have more opaque or imprecise financials, and also will allow you to act more quickly to take advantage of any unexpected strategic opportunities.

Our mission at Service Leadership is to enable Solution Providers to deliver excellent returns to their shareholders, exceptional career opportunities to the brightest young people joining the workforce, outstanding partnership to their vendors, and indispensable value to their customers. All of this starts with a proper foundation for measuring financial and operation performance: the Normalized Solution Provider Chart of Accounts™.