Using the Service Leadership Index® Normalized Solution Provider Chart of Accounts™

Enabling the Measurement and Comparison of Profitability and Best Practices

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Which Audience Are You?

Please note as you read this document, if you are:

- **A Service Leadership Index® (S-L Index™) subscriber**, this document will help you construct a financial report that will enable you to most easily complete your quarterly S-L Index benchmark survey. You will find specific references to fields used in the S-L Index survey along with instructions for using those fields to complete the survey.

  (Note: Although you do not need to change your chart of accounts to participate in the S-L Index, should you desire, this document will also help you to design your chart of accounts to provide management with maximum visibility into and control over how the company is performing financially).

- **Not an S-L Index group member**, you will find valuable information about how to "normalize" or structure your chart of accounts to provide management with maximum visibility into, and control over, how the company is performing financially. Note that there are sections of this document containing specific references to the S-L Index survey used by companies who subscribe to the S-L Index benchmark service. These sections can provide you with additional insights, but they are not specifically relevant to constructing and organizing a best-in-class IT solution provider chart of accounts. These sections of the document have been marked with the following S-L Index logo:

(Note: Learn more about the S-L Index benchmarking service and how to subscribe.)

Why a Normalized Solution Provider Chart of Accounts?

The Normalized Solution Provider Chart of Accounts (NSPCoA™) was created for two reasons. First, 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 NSPCoA has been developed over 25 years of experience running IT Solution Provider (TSP) businesses large and small, as well as diagnosing the financial and operational challenges of TSPs with whom we work with to improve their results or complete a merger and acquisition deal.

The NSPCoA enables the effective management of a TSP 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, TSPs can objectively evaluate which practices produce best-in-class results—and thus truly are best practices—leading to a meaningful and sustained change for the better.

Sorting Out the Revenue

Income statements start with revenue and that's where the NSPCoA starts. The 10 categories or accounts into which the TSP's revenue will be broken down are as follows:

- Product Resale (HW/SW/HaaS/Cloud Services Resale) Revenue
- Software Licenses (Own) Revenue
- Infrastructure – Technical Services Revenue
- Infrastructure – Professional (Project) Services Revenue
- Infrastructure – Managed Services Revenue
- Infrastructure – Shared Infrastructure Services Revenue
- Applications – Technical Services Revenue
- Applications – Professional (Project) Services Revenue
- Applications – Managed Services Revenue
- Commissions and 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, when doing a valuation or describing the business of the company to an outside investor who is not intimately familiar with our industry, these categories most clearly distinguish all the major services a given TSP may offer.

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

Each of the 10 categories generate value in a unique way, which is essential for an investor to understand. As it turns out, this makes the same 10 categories an excellent way to measure the components of value in a given TSP and compare them with those of other TSPs.

The critical tactical reason for choosing these 10 categories comes from the opposite: How is work most effectively organized within a TSP 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 is 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 firsthand—you are trying to get a team of "hybrid" engineers to correctly utilize their time when serving both time and management (T&M) customers and managed services customers.

Ironically, the TSPs who have the easiest time at this "new" hybrid model, are those who started way back in the 1970s and 1980s, 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 NSPCoA 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 TSP.

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 NSPCoA 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 10 revenue accounts and understand what goes into them.

The 10 Revenue Accounts

We earlier saw the 10 revenue accounts:

1. Product Resale (HW/SW/HaaS/Cloud Services Resale) 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 the IT solution industry work against delivering value in this scenario, the gross margin you can win for this offering 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 generate 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 (LOB) 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 delivered by your own labor, which we'll come to later). These include:

- Hardware

- Software (that you didn't write)

- "Packaged" services of others, such as vendors' maintenance contracts

- "Real" services of others where you don't manage the people doing the work (i.e. when they're not contractors under your direction)

- HaaS revenue where you are reselling hardware to the client on a subscription basis. This would be any case where you are charging the client monthly for the use of hardware (and the client is not taking title to the hardware).

- SaaS revenue where you are reselling a vendor's software on a subscription basis

- "Real" centralized services of others—such as white label (you apply your own brand; vendor brand not visible to customer) or third-party branded (vendor brand visible to customer) help desk, back-up, network monitoring and management, etc.—which we categorize as cloud services resale, whether sold with your brand (white label) or the vendor's brand (third-party branded) visible to the customer.

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 Cost 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.

Software Licenses (Own) Revenue

This section is designed to capture revenue from packaged (commercial) software that you have built/developed/published or to which you have exclusive rights. 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 NSPCoA. 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 TSPs, the 10 main categories represent the majority of their revenue and profit sources. Simply put, these additional potential practices are either not offered by many TSPs, 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 NSPCoA and the resulting benchmarking process. Balancing ease of use with materiality made it clear that these less common, often much smaller LOB would be incorporated into the more material LOB. After all, this is most likely how they are managed within the TSP as well.

That said, we are aware from long experience that some LOB, which may not be material today, can represent good profit growth opportunities in the future. We are constantly reviewing benchmark results, TSP feedback, and income statements from TSPs we work with , to keep an eye on which of these LOB might be elevated to NSPCoA status. As new LOBs that generate

material value come to light, we endeavor to identify and evaluate them and continue to evolve the NSPCoA 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 T&M—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 LOB 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 TSPs 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 TSPs develop the sales and service maturity to safely switch to flat fee projects, the added complexity within the NSPCoA 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 LOB 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 LOB packaged applications (such as accounting systems); and 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. 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 include 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 LOB 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 include 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 application service provider (ASP) basis or SLA-based services related to keeping your customer's applications running properly. These include:

- 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 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 your 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 your client and invoices the client directly. The manufacturer then sends you a commission for the product sale.

Typically, you will have no COGS 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.

Recurring vs. Non-Recurring Revenue

In the TSP industry, recurring revenue and non-recurring revenue are two different types of revenue streams described in the revenue accounts above.

Recurring Revenue: Recurring revenue refers to the predictable and regular income that a TSP receives on a monthly basis. This revenue is considered stable and reliable since it is expected to continue over an extended period, providing a foundation for the TSP's financial stability and growth. It typically comes from long-term contracts or subscriptions with clients for services such as the following:

- Infrastructure – Managed Services
- Infrastructure – Shared Infrastructure Managed Services
- Applications – Managed Services
- HaaS (Hardware as a Service)
- Cloud resale (public cloud)

Non-Recurring Revenue: Non-recurring revenue, also known as one-time or project-based/hourly revenue, is generated from ad-hoc or non-repetitive services provided by the TSP. Non-recurring revenue is not predictable or consistent since it depends on the occurrence of specific projects or events. This includes the following offerings.

- Infrastructure – Technical Services
- Infrastructure – Professional (Project) Services
- Applications – Technical Services Revenue
- Applications – Professional (Project) Services Revenue
- Hardware Product Resale

While both recurring and non-recurring revenue contribute to an TSP's overall income, recurring revenue is often considered more valuable as it provides a steady cash flow and builds a foundation for improved customer retention and long-term business sustainability. Non-recurring revenue can be more variable and dependent on market conditions or client demands.

Core Recurring Revenue vs. Core Non-Recurring Revenue

Additionally, revenue is broken down into categories that are considered "core", which denotes the higher gross margin potential, greater management skill, higher risk and greater potential stock value of the services delivered by the TSP's staff, as opposed to product resale. This enables appropriate focus by the management team.

Core Recurring Revenue consists of the service-related lines of business for Infrastructure – Managed Services, Infrastructure – Shared Infrastructure Managed Services, and Applications – Managed Services. It specifically does not include cloud resale (whether branded or white-label). That is because cloud resale does not have the gross margin and stock value potential, nor the payroll risk, of the TSP's self-delivered recurring services (MSP and shared services).

Core Non-Recurring Revenue consists of the service-related lines of business for Technical Services and Professional (Project) Services for both Infrastructure and Applications. It specifically does not include hardware product resale. That is because hardware product resale does not have the gross margin and stock value potential, nor the payroll risk, of the TSP's self-delivered non-recurring services (Technical and Projects).

Cost of Goods Sold (COGS)

While TSPs 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 COGS. It is also important to track COGS separately for each significant 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 on the next page.

Example A	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%

Example 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 is 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, and where to make investments. The COGS entries available to you in the S-L Index will enable you to have this critical view of how each LOB is performing.

Product Resale Hardware/Software (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. This is the net of what you paid to the manufacturer, less any vendor rebates (which should be entered separately as a negative number to HW COGS).

Software COGS: The price you paid to the software vendor for any software you have resold. This is the net of what you paid to the manufacturer, less any vendor rebates (which should be entered separately as a negative number to SW COGS)

Hardware as a Service (HaaS) COGS/Depreciation: The costs you incur in order to provide Hardware as a Service to clients. This could be the amount you pay to a third-party leasing company for the hardware you have deployed to clients. If you have purchased and are depreciating the hardware, then enter the quarterly depreciation for the hardware here in HaaS COGS. Do NOT also add this depreciation expense to the Depreciation expense found under your General & Administrative expenses, this cost is solely COGS to support the revenue from your HaaS offering.

Other examples of Product Resale Hardware/Software COGS would consist of the following:

- COGS for "packaged" services of others, such as vendors' maintenance contracts
- 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)
- COGS for "real" centralized services of others, such as white label or third-party 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 four subcategories and Application Practice has three). The methodology for COGS data capture is exactly the same for all seven of these services subcategories, and consists of the following three items[1]:

- Hard COGS

- Direct Labor Wages COGS (W2 in US, T4 in Canada, P60 or PAYE (pay as you earn) in UK, Income Statement in Australia, Gross Earnings in New Zealand)[2]

- Contractor Labor COGS (1099 in US, off-payroll workers in UK)

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[1] There is a fourth item only for Infrastructure Managed Services COGS: Outsourced Master MSP Expense COGS
[2] Benefits are inclusive of both non-financial (cell phones, company cars) and financial benefits such as employer 401K (US), other retirement or pension (Super in Australia) contributions.

Let's examine each of these separately.

Hard COGS

Hard COGS consist 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 Wages COGS

This COGS line item is designed to capture the wages 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 wages 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.

Contractor Labor COGS

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

Outsourced Master MSP Expense COGS

This COGS line item applies only to Infrastructure Managed Services COGS. This is the total amount paid by your company to a Master Managed Services Provider (Master MSP) for the quarter, whether for outsourced tools and monitoring or labor, or both, performed in support of your managed services practice.

Using these three categories (four for managed services) for capturing Service COGS enables simplicity, accuracy, and consistency across all TSPs' Charts of Accounts.

A common question that arises when one or more of a TSP's technical professionals supports more than one LOB is how to best allocate the cost of that professional against multiple LOBs?

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 they support.

However, if you are like most TSPs, 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 LOBs. 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.[3]

If the professionals who provide service delivery against multiple LOBs 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 S-L Index will automatically calculate the gross margins for each LOB where you have entered revenue and COGS.

Expenses (Selling, General and 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 S-L Index 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

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[3] *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.*

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 just couple of these operating expense entries:

E1s. IT Sales Department Compensation Expense: This line item is for compensation expense only for all sales personnel. It should include inside/outside sales, order entry, sales management, etc. If the owner spends 75% of their time running the business and 25% of their time managing sales, then 25% of the owner's compensation should be recorded here in E1s. Remember that here, and anywhere you are entering wages data, you need to include an allocation for employee benefits and payroll taxes.

E1as. IT Sales Non-Labor Expense: This is to capture all non-labor IT sales expenses; e.g., travel & entertainment; cell phones and laptops for IT sales staff, etc.

E1m. IT Marketing Department Compensation Expense: This line item is for compensation expense only for all marketing personnel. Remember that here, and anywhere you are entering wages data, you need to include an allocation for employee benefits and payroll taxes.

E1am. IT Marketing Non-Labor Expense: All non-labor IT marketing expenses; e.g., SEO; cost to produce marketing seminars, collateral; newsletters; marketing travel & entertainment; cell phones and laptops for IT marketing staff, etc.

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, and 25% of their compensation recorded in E1.

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 (FTEs) who 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 works 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; they only work 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 TSPs is recorded.

If the owner spends 75% of their time running the business and 25% of their time managing sales, then 0.75 should be entered in "O34. Number of C-Level Executives.", and 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 who are 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 who 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. And be sure to include contractors as FTEs in your headcount.

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 their 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 financial 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 for companies of your size and number of principals.

The objective here is to identify the number of principals who are actively involved in running the business. This number will be used in the S-L Index 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 U.S.; 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 two 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 who 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 as an expense on 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 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."

Research & Development (R&D)

This section is designed to capture information on Research & Development investment by the firm on new solutions and offerings.

IMPORTANT NOTE: This "R&D Investment" section is completely separate and discrete from all sections that precede it in the S-L Index. Your data entry here will be used to identify the amount of both labor and non-labor investment your company is making in R&D. When you enter the data for costs below, you will not be double counting data entered in previous sections (e.g., Service COGS, Sales Labor, G&A Labor, etc.). All data entered here should reflect numbers for the past quarter only.

The objective is to identify the amount a TSP invests in R&D on an ongoing basis. These costs would include investments coming from sales, engineering, and management, and also non-labor investment.

- RD1. Engineering Labor Expense – Enter the amount of expense for all technical team members that was spent on R&D. If a given engineer was paid $20,000 in the quarter (including benefits and payroll taxes) and spent 10% of their time on R&D in the quarter, enter $2,000 in this field.
- RD2. Sales & Mktg Labor Expense – Enter the amount of expense for all sales and marketing team members that was spent on R&D. If a given marketing person was paid $18,000 in the quarter (including benefits and payroll taxes) and spent 30% of their time on R&D in the quarter, enter $5,400 in this field.
- RD3. General Management Labor Expense – Enter the amount of expense for all general management team members that was spent on R&D. If a given general manager was paid $30,000 in the quarter (including benefits and payroll taxes) and spent 20% of their time on R&D in the quarter, enter $6,000 in this field.
- RD4. Non-Labor Expensed Cost – Enter the amount of dollars that appeared on your Income Statement for the quarter as non-labor expenses incurred specifically for R&D (e.g., purchased software or hardware where these items were **expensed**, and non-labor sales and marketing expense).
- RD5. Non-Labor Depreciation Cost – Enter the amount of dollars that appeared on your Income Statement for the quarter under "E6. Depreciation" for non-labor expenses incurred specifically for R&D (e.g., purchased software or hardware that you **depreciated**).

Leveraging the NSPCoA

By now you have realized that this NSPCoA 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 TSP business. So structured, you can use your new chart of accounts in valuable ways:

- Deliver actionable gross margin and sales cost reporting to best manage the business based on trailing results.

- Used as budget categories, this NSPCoA enables you to set budgets for all of your revenue- and cost-generating activities or departments, enabling better forecasting.

- When items one and two are implemented together, you can produce budget vs. actual reports which are easy to analyze, enabling quick response to developing situations.

- 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.

Once you have item three 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 NSPCoA, 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.

This NSPCoA 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 TSPs 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 TSPs 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 NSPCoA.

Appendix

Appendix 1 – Journal Entry Quick Reference Guide				
Type	**CoA #**	**Debit**	**Credit**	**Financial Statement**
Assets	1000	Increase	Decrease	Balance Sheet Accounts
Liabilities	2000	Decrease	Increase	
Equity	3000	Decrease	Increase	
Revenue	4000	Decrease	Increase	Income Statement Accounts
COGS	5000	Increase	Decrease	
Expenses	6000	Increase	Decrease	
Expenses	7000	Increase	Decrease	
Other Income	8000	Decrease	Increase	
Other Expenses	9000	Increase	Decrease	

Appendix 2 – Sample Chart of Accounts	
Account #	**Description**
Balance Sheet: Assets	
1001	Primary Checking
1004	Petty Cash
1010	Business Savings
1030	Payroll Checking Account
1200	Accounts Receivable
1300	Merchandise Inventory
1400	Supplies
1440	Prepaid Expenses
1450	Other Current Assets
1500	Furniture and Fixture
1520	Vehicles
1530	Buildings
1690	Land

Appendix 2 – Sample Chart of Accounts	
1700	Accumulated Depreciation, Furniture and Fixtures
1710	Accumulated Depreciation, Supplies
1720	Accumulated Depreciation, Vehicles
1730	Accumulated Depreciation, Buildings
Balance Sheet: Liabilities	
2000	Accounts Payable
2010	Wages Payable
2200	Other Current Liabilities
2300	Unearned Revenue
2400	Interest Payable
Balance Sheet: Owners Equity	
3000	Opening Equity
3100	Capital / Capital Partner 1 / Capital Stock
3200	Draws /Distributions / Dividends
Income Statement: Revenue	
4010	Servers, Storage, Network, Security, PC Revenue
4020	Printers Revenue
4030	Telephony (VoIP, Traditional) Revenue
4040	Services
4050	Consulting
4090	Sales Discounts
4100	Packaged Software – Licenses Revenue
4110	Packaged Software – Vendor Maintenance Revenue
4115	Cloud White Label (SP Branded) Services Revenue
4117	Cloud 3rd Party Branded Services Revenue
4120	Software License (Own Software) Revenue
4130	Software Maintenance (Own Software) Revenue
4131	Misc. Software (Own Software) Revenue
Infrastructure Practices Revenue	
4200	Break/Fix Revenue
4220	Cabling Revenue

Appendix 2 – Sample Chart of Accounts	
4230	Infrastructure Staff Augmentation Revenue
4240	Infrastructure Training Revenue
4250	Misc Infrastructure Technical Services Revenue
4260	Traditional Telephony Installation Projects (POTS) Revenue
4270	Security Projects Revenue
4280	Network Integration Projects (incl Desktop Projects) Revenue
4290	IT Operations/Management Consulting Revenue
4300	VoIP/IPT-related Projects Revenue
4310	Misc Infrastructure Professional (Project) Services Revenue
4320	Network Management/Admin (On-Site) Revenue
4330	Desktop Services (incl Dedicated On-Site B/F) Revenue
4340	Help Desk (Remote) Revenue
4350	Network Management/Admin (Remote NOC) Revenue
4360	Security Management Revenue
4370	Telephony Management Revenue
4380	Cabling Management (AMCs) Revenue
4390	Help Desk (On-Site) Revenue
4410	Managed Services Provider Revenue
4420	Insurance-type Maintenance Contracts Revenue
4430	Printer Management, Pay-for-Print Revenue
4440	Misc Managed Services Revenue
4450	Internet Service Provider Revenue
4460	Remote Backup and Disaster Recovery Services Revenue
4470	Hosting and Colocation Services Revenue
4480	Misc Shared Infrastructure Services Revenue
Applications Practices Revenue	
4500	Application Development Staff Augmentation Revenue
4510	Application Development Training Revenue
4520	Applications Documentation Revenue
4530	Misc Applications Technical Services Revenue
4540	Application Development (Custom) Revenue

Appendix 2 – Sample Chart of Accounts	
4550	Packaged Applications Install/Config/Customization Revenue
4560	Misc Application Professional (Project) Services Revenue
4570	Application Service Provider Revenue
4580	Application Performance Monitoring Revenue
4590	Database Administration Revenue
4595	Misc Applications Managed Services Revenue
Commissions & Agency Revenue	
4600	Telephony Agency Revenue
4610	Product Resale Agency Revenue
4620	ASP Agency Revenue
4630	Misc Commission/Agency Revenue
Cost of Goods Sold (COGS)	
5010	Product #1 Cost
5011	Product #2 Cost
5015	Cloud White Label (SP Branded) Services Resale COGS
5016	Cloud 3rd Party Branded Resale COGS
5025	Product #3 Cost
5100	Raw Material Purchases
5110	Direct Labor
5120	Indirect Labor
5200	Commissions
5210	Infrastructure Professional (Project) Services Direct Labor Payroll COGS
5220	Infrastructure Professional (Project) Services Direct Labor Contractor COGS
5300	COGS, Salaries and Wages
5310	COGS, Contract Labor
5320	COGS, Freight/Shipping
5400	Shared Infrastructure Services Hard COGS
5410	Shared Infrastructure Services Direct Labor Payroll COGS
5420	Shared Infrastructure Services Direct Labor Contractor COGS
5500	Applications Technical Services Hard COGS
5510	Applications Technical Services Direct Labor Payroll COGS

Appendix 2 – Sample Chart of Accounts	
5520	Applications Technical Services Direct Labor Contractor COGS
5600	Application Professional (Project) Services Hard COGS
5610	Applications Professional (Project) Services Direct Labor Payroll COGS
5620	Applications Professional (Project) Services Direct Labor Contractor COGS
5700	Applications Managed Services Hard COGS
5710	Applications Managed Services Direct Labor Payroll COGS
5720	Applications Managed Services Direct Labor Contractor COGS
5800	Commissions & Agency COGS
5990	COGS, Other
Operating Expenses	
6100	Sales Department Compensation Expense
6110	Sales & Marketing Non-Labor Expense
6120	Salaries W-2
6200	Rent
6204	Repairs
6210	Utilities
6220	Advertising
6240	Miscellaneous
6820	Taxes
6821	Payroll Taxes
6824	FICA/MED
6830	Federal
6835	Federal Unemployment
6840	Local
6850	Property
6855	Taxes - other
6860	State
6899	Penalties and Interest - Tax
6260	Printing
6263	Licenses and Fees
6265	Depreciation

Appendix 2 – Sample Chart of Accounts	
6266	Amortization
6270	Professional Fees
6280	Legal Fees
6285	Accounting Fees
6289	HR Fees
6340	Telephone
6341	Cell
6342	Office
6343	Fax
6345	Web Access
6346	Conference Calls
6350	Travel and Entertainment
6351	Client - Travel and Entertainment
6353	Sales - Travel and Entertainment
6360	Meeting Expenses
6370	Business Insurance
6371	Errors & Omissions
6372	General Liability
6374	Workmen's Comp
6410	Interest Expense
6420	Bank Fees
6430	Bad Debt Fees
6550	Office Supplies
6551	Computer Hardware
6552	Computer Software
6560	Payroll Expenses
6561	Employee Benefit Expense, Health Insurance
6562	Employee Benefit Expense, Pension
6563	Employee Benefit Expense, Other
6565	Bonus Expense
6720	Services

Appendix 2 – Sample Chart of Accounts	
6723	Hosted Backup
6726	Hosted email
6728	Co-LO
Non-Operating Revenues and Expenses, Gains and Losses	
7010	Interest Income
7030	Other Income
8010	Other Expenses
9010	Gain on Sale of Asset
9060	Loss on Sale of Asset

Contact Us

If you have any questions, please contact info@service-leadership.com.

About Service Leadership, Inc.®, a ConnectWise solution

Service Leadership is dedicated to providing total profit solutions for IT solution providers (TSPs), directly and through industry consultants and global technology vendors. The company publishes the leading vendor-neutral, TSP financial and operational benchmark: Service Leadership Index®. This includes private diagnostic benchmarks for individual TSPs and their business coaches and consultants. The company also publishes SLIQ™, the exclusive web application for partner owners and executives to drive financial improvements by confidentially assessing and driving their Operational Maturity Level™.

For more information about Service Leadership, please visit www.service-leadership.com.