

Week Three

The Consulting Service.

The local newspaper says “Ricky’s orange juice business is the best in town.” It’s only been two weeks that Ricky has been in business and already his fame is spreading!

Some of the neighborhood kids start coming to you for advice about starting their own orange juice business. “Wow, should I do this?” You ask yourself. You have to consider your own business. These kids are asking you to help create competition for yourself. You decide you will definitely not work with anyone near enough to open a stand in your own neighborhood.

The demand is such that - being a genius on your good days - you realize this means that to do this you have to start a second business yourself! But you’re only one person. How can you run both your own orange juice stand and a consulting business? Do you really want to expand? Do you want to become a consultant?

Finally, you realize that you need some consulting and call your favorite aunt for some advice. Aunt Maria has run her own management consulting firm for years. “How will I be able to run two businesses?” You ask Maria. Your aunt says you will have to hire some friends and let them start out running the stand and you can train them to be consultants. Your next question is, “Should I combine my financial records for the consulting firm with the orange juice stand financial statements or set up a separate business?”

Maria says “Ricky, you can do either”, but reminds you that consulting is a different kind of business - it’s a service business. You immediately remember what we all learned in the last week - service businesses do not have inventory and can gain a tax advantage by using the Cash Method of accounting for reporting to the IRS.

You figure that’s for you and decide to start a second business - Ricky’s Consulting Company. Next you ask Aunt Maria how to charge for your consulting services. She starts talking about “billable hours” and you say, “Huh?” What she means is that service businesses are all about managing and optimizing the use of time. At the orange juice stand you have to manage your product, orange juice, and your time, but a consultant’s only inventory is his or her time. Aunt Maria says that what this means is you don’t make money unless you are doing something that you can bill to the customer. You need to come up with an hourly or daily billing rate.

You ask Maria if the Balance Sheet and Income Statement are different for a service business. Maria asks you to get out a Balance Sheet from your orange juice stand. She is impressed by how well organized you are and particularly by how you have learned to understand the Balance Sheet items. She asks you what is the one item on your orange juice stand Balance Sheet that will not be on a service company’s Balance Sheet. “Inventory,” you tell her. That’s the only difference if you are using the Accrual Method of accounting.

Aunt Maria says the Income Statement is a different story. She says that since there is no Ending Inventory to subtract out of costs, services companies really only have Sales and Expenses. That makes it really easy to do your Income Statement. You start to feel agitated.

“Aunt Maria,” you say, “wouldn’t a service company want to separate its overhead costs to run the daily operation from its direct costs?” Aunt Maria says that, indeed, most service companies separate costs into two categories - Cost of Services and Expenses. Cost of Services are the costs directly related to providing a service. Expenses are all the overhead costs or costs to run the business, just like in our orange juice stand. As we noted earlier, the structure of such a service company’s Income Statement would be:

Sales	\$ <input type="text"/>
Cost of Services	(<input type="text"/>)
Gross Profit	<hr/> <input type="text"/>
Expenses	(<input type="text"/>)
Net Profit	\$ <input type="text"/> <hr/> <hr/>

Many of you reading this mini-course either work in service companies or for large companies with inventory that have service divisions. The purpose of this first day of the week is to help you better understand service company issues and accounting and give you a chance to do some practice determining which items go into Cost of Services (some people call it Cost of Sales) and which into Expense. For now, take a pause. We will get back to Ricky's orange juice stand in the next few days.

Please don't confuse what we are doing in this brief week on service businesses with your orange juice stand business. **The numbers here will not affect what we've done earlier in previous weeks.** Consider this an exercise to learn a consulting business operation. It's a question of apples and oranges. Since the Balance Sheets for the two types of companies are the same (except for Inventory), we will not focus on the Balance Sheet at all in this part of the week.

Now, let's pretend to shoot forward in time a couple of months. You did hire some friends who learned your business' core competencies rapidly. Thanks to the article in the local newspaper and great word of mouth, your new consulting business and its two employees get busy in a hurry. Encouraged by this response, you take out a classified ad for the business.

Your younger brother Alan wants to get involved, so you promise him a \$1 sales commission on any contract he brings into the business. Okay, let's go consult! Hot after sales leads, Alan sends the newspaper article to your dad's half sister, Cindy and her husband, Eric. They have two kids, your cousins, Amanda and Laura, who want to start an orange juice stand and be just like you.

You sell Aunt Cindy three days of consulting, for two consultants at \$8 per day for each consultant, and include all travel costs in the daily rate. They live in the next town which is 30 miles away, requiring two overnight stays in a local hotel for your two consultants. Luckily, your employees' parents volunteer to go along and pay for the hotel.

The cost for travel (gas for cars) comes to \$6. Plus, you pay the consultants \$2.00 per day for every day they work with clients. Your younger brother, Alan, agrees to do the administrative work for the contract and other office tasks. You pay him \$2 for the week. You also give him the \$1 sales commission he earned by selling this job to Aunt Cindy. Since the newspaper article brought you such a good response, you decide to continue the ad in the next issue. Advertising the new business costs \$4.

Your two consultants (Amanda and Laura) work Monday, Tuesday, and Wednesday with the clients. They take along \$2 worth of oranges and \$1 worth of sugar to demonstrate how to make orange juice, in case your cousins decide to go with your amazing, awesome, totally appetizing secret recipe.

On Thursday, back home, they work all day developing a new consulting product for your Orange Juice Consulting Company to sell (It's a leadership course for shy kids called, "DON'T BE SHY, BUY IT NOW!"). You only pay the consultants \$1.50 per day when they are working at the office. On Friday, they performed general and administrative tasks at the office.

Now, it's time to practice. Using the above transactions, complete the following Income Statement for the Consulting Company. Your main task is to determine which items go into Cost of Services and which go into Expenses.

Remember, Cost of Services is any cost directly related to providing the service, and Expenses are all the cost of doing business not directly related to providing the service.

Talking Points

Note. In general, Income Statements take care of any financial activity you develop and are organized into three sections. The first section shows the Revenues earned from the sales of your products or the sales of your services for the period being reported. The second section lists the Expenses the business has incurred to earn these Revenues during the period represented by the Income Statement. The third section is the difference between these Revenues and Expenses in which we hope the Revenues outweigh the Expenses, indicating a profit. If the Expenses are greater than the Revenues, this would indicate a loss - not a great thing in a business.

SERVICE BUSINESS INCOME STATEMENT		
SALES		<input type="text"/>
COST OF SERVICES (COST OF SALES):		
_____	<input type="text"/>	
_____	<input type="text"/>	
_____	<input type="text"/>	
TOTAL COST OF SERVICES		<input type="text"/>
GROSS PROFIT		<input type="text"/>
EXPENSES		
_____	<input type="text"/>	
_____	<input type="text"/>	
_____	<input type="text"/>	
TOTAL EXPENSES		<input type="text"/>
NET PROFIT		<input type="text"/>

Okay, let's see how you did.

The client (Aunt Cindy and Uncle Eric) bought three days at \$8/day per consultant. You sent two consultants. So, what was the total revenue? **\$48.00** What did you put into Cost of Services? **Well, you had to pay your consultants \$2.00/day times 2 consultants times 3 days = \$12.00 You had to pay for their travel costs (\$6.00). They took along \$3.00 worth of product which was used for demonstration purposes and left with the client.**

So, your Cost of Services are? **\$21.00**. Now, what items were in Expenses? **Remember - Expenses are costs not directly related to the delivery of services.**

You paid Alan a sales commission (\$1.00) and paid for some advertising in the newspaper (\$4.00). Alan also did the administrative work for the contract and other office tasks (\$2.00). Then, on Friday, your consultants, each earning \$1.50, spent the day performing administrative tasks at your office. There's one more expense. How much did "DON'T BE SHY-BUY NOW!" cost you to develop? **\$3.00 for Research and Development**. So, what are the total expenses? **\$13.00**.

We're almost done. Last thing, subtracting Expenses from Gross Income leaves us with a Net Income of...? **\$14.00**. (\$48 - \$21-\$13=\$14).

Now, you may be wondering about a few things. One may be how we handled the sales commission. Some of you may want sales commission to go in Cost of Services, since you can argue that it is a direct cost of the sale. But is it truly a part of the cost of delivering the service? Not really. Because of this, many businesses put sales Commission in Expenses. Either way you did it is fine by accounting standards and by the IRS. What is required is that you be consistent in how it's reported. (Consistency is strong principle of accounting).

Travel costs may be another area you're wondering about. Travel costs are in Cost of Services because they are part of delivering the services by contract. Most real-life consulting companies make the client reimburse any and all travel costs. If travel is reimbursed dollar for dollar, it is handled as a non-revenue item in a separate account.

How come your employees' wages show up in different categories? Because consultants' wages are in Cost of Services only when they are working on a project. Their relative time as consultants, doing administrative tasks, and R&D (Research and Development) lets us know how efficiently we are using their time (which is the only source of the consulting company's revenue). Not all service companies have R&D, but for those that do, separating it allows you to keep track of how much capital investment goes into new products. This is helpful in determining how to price them.

Review your Income Statement again. Does anything concern you? What are potential problem areas? How would you improve this company's profitability? Remember we said earlier that time is the critical issue in a ser-

vice company. You might question the wisdom of using the consultants for administrative tasks. Their salaries are much higher than Alan's for performing these tasks. Lots of service companies get into financial difficulties when they end up having too much time when their services providers are not working directly for clients on "billable hours", like public accountants, lawyers, etc.

What else haven't we covered in this brief side trip? Certain types of expenses, for one, interest expense, other expenses, and taxes would have to be subtracted to arrive at the true bottom line after taxes. You may wonder what "other expenses" mean. These are things like a loss or gain from selling a fixed asset (which we haven't done).

Well, we certainly haven't exhausted a discussion about service businesses and how to treat them accounting-wise. But, hopefully, you know some of the things to keep in mind if you're in a service business.

Below is, our Income Statement with the major categories used by typical service companies.

RICKY'S CONSULTING CO.	
INCOME STATEMENT	
SALES	\$48.00
COST OF SERVICES	21.00
GROSS PROFIT	<u>27.00</u>
EXPENSES:	
Sales and Marketing	\$5.00
General and Administrative	5.00
Research and Development	<u>3.00</u>
TOTAL EXPENSES	<u>13.00</u>
NET PROFIT	<u><u>\$14.00</u></u>

Hey! Ricky, you like having a second business. Maybe one day you'll sell your orange juice stand and concentrate on being a consultant full-time. For now, though, you enjoy making a product and selling it. So, let's leave the consulting world for a while and return to the best-tasting orange juice in the whole wide world!

After all, week three is about to begin!

Talking Points

Organizing Your Record-Keeping. You should now have a basic understanding of the interrelationship of each of the phases in record-keeping. Just as timing is important to all other phases of your business, it also is important when you deal with record-keeping with different kinds of businesses. You cannot randomly throw all of your paperwork into a basket and deal with it in a sporadic nature. You will have to organize your record-keeping into a system that will allow you to proceed through the tax year in an orderly fashion. That system will have to provide for retrieval and verification of tax information and, at the same time, form a picture of your business that will help you to analyze trends and implement changes to make your venture grow and become more profitable.

Building Your System. The information in this mini-course has been presented in a particular order for a specific reason. Just as a home builder must first lay the foundation, do the framing, put up the walls, and then do the finish work, you too, must build your foundation first and learn the basics of record-keeping and accounting. The frame can be likened to your General Records. They are the underlying material without which there could be no walls. In the same way, General Records are the basis (source of information) for forming Financial Statements. At last, the builder finishes the home and makes some rooms into a limited space for each family member and other