

# The Business of Consulting

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## Abstract

Consulting provides you with the opportunity to spend more time doing what you enjoy and hopefully what you do best. Unfortunately, you must look at consulting as a business regardless of your area of expertise. Before taking the plunge into consulting, you should consider how you want to work (alone or in a group), where you want to work (onsite or offsite), what is required to work (taxes, permits, hardware, software, etc.), who would pay for you to work (potential clients), and what it takes to make a profit (rates, billable hours, and expenses). Once you have evaluated all of these details, you can safely decide whether you have the personality and motivation to run a successful consulting business.

## Introduction

Before reading about my observations or accepting my recommendations, you should understand what my experience has been and what my biases are. In 1990 I started a small software consulting company called Meridian Software, Inc., which consisted of one employee. I specialized in SAS software and accepted my first contract as an onsite hourly consultant for a large pharmaceutical company. Within the first year, my client permitted me to work offsite (at home) and I started hiring subcontractors to help with my increasing workload.

Because my niche was SAS software and not specifically pharmaceuticals, I sought additional contracts in other industries. In January of 1991, I hired two permanent employees and started my first fixed-fee project. We grew quickly over the next three years, hiring permanent employees rather than relying on subcontractors, but have been oscillating between 9 and 10 employees since 1994.

Over the past three years, I have been evaluating and experimenting with further growth and building infrastructure that would support growth. Most importantly, I want to be sure that continued growth will move all members of the Meridian Software team toward their personal goals, which are sometimes forgotten during fast and furious growth.

To help you decide how and if you want to pursue the life of a consultant, I will discuss the following issues:

- Your current situation
- Types of consultants
- Reasons for using a consultant
- Reasons for becoming a consultant
- Managing the business

## Your current situation

Before you jump into the consulting business, you should examine your abilities and personality. A multitude of books exist on the market that offer self-evaluation questionnaires, but they all distill down to four major issues:

- Are your skills in demand?
- Are you self motivated?
- Do you have any business sense?
- Are you a risk taker?

The first two characteristics are essential. Most really good consultants possess not only skill, but experience in the real world.

Business sense is a rather vague term, but that is because there are multiple combinations of personal attributes that can lead to success. Business sense can be learned or purchased, but knowing how to run a business certainly increases your chances for success. I include marketing skill within the category of business sense. You may be the most talented statistician or programmer in the world, but unless you know how to spread the word, you will not succeed in business.

Risk is a relative term in today's environment of downsizing and rightsizing and is not as important a factor as it used to be. But, if you do not enjoy some uncertainty or a little tension occasionally, you should think twice about operating your own consultancy.

## **Types of consultants**

First, we can make the distinction between contractor and consultant. The contractor is a specialized form of consultant that basically performs the work of an employee and is managed by the client as if they were an employee. Consultants, however, have historically offered a more advisory service relating their vast experience to the client. Today, however, these two distinctions have faded, especially in the data processing field. The two terms are often used interchangeably. In this discussion, we will use the term consultant.

As a consultant, you may find yourself working

- Onsite – at the client's place of business
- Offsite – working at your office, but directly for the client on a daily basis. This may involve dialing into the client's site via modem.
- Offsite – working at your office and independently on a well defined project.
- All of the above – mixing all of the methods listed above.

The approach you take to consulting depends on the services you provide and your preferred working situation. Not all consulting services can be provided remotely, so if you want to work at home, for example, be sure to offer a service that can be rendered from home.

Consultants now have many options for working independently or as a team . They can work

- Alone – performing all services and finding all work independently. You are responsible for all services, business decisions, and marketing. No clients means no income.
- Alone for a placement agency – performing all services alone, but marketed by an agency that finds work for consultants. Placement agencies usually know very little about the services you provide. If they cannot place you, you are on your own.
- Alone and onsite for a consulting firm – working directly for a client onsite, but placed by a consulting firm that usually has some knowledge or specialty in your line of service. Generally, you only need to worry about performing your responsibilities. The consulting firm will take care of business details and payroll. Most consulting firms will keep you on the payroll between projects up to a specified time limit.
- In a team for a small consulting firm – working primarily with the employees of the consulting firm. Client contact depends on the role the consultant plays on the team. This arrangement offers the variety of independent consulting with the benefits of permanent employment.
- In a team for a large consulting firm – working primarily with the employees of the consulting firm. Client contact depends on the role the consultant plays on the team. Large firms tend to win bigger contracts, which sometimes makes the work feel less like consulting and more like permanent employment. Individually, you have much less control.

The type of consultant you choose to be depends on the level of control you want, the amount of risk you can tolerate, and the working style you prefer.

## Reasons for using a consultant

Clients hire consultants for one or more of the following reasons:

- To quickly obtain expertise they do not currently have (or to get fresh new ideas).
- To replace lost employees, quickly and temporarily
- To increase manpower during an emergency situation or to meet a deadline
- To observe you in action before tempting you with a full-time offer of employment
- To find skills they cannot hire permanently, because everyone who has the skill is either gainfully employed or is a consultant
- To save money

Hiring good consultants is usually cheaper than hiring permanent employees, because experienced and qualified consultants can complete the projects sooner and do not hang around when the job is done. The client does not need to pay for benefits or pay for idle time.

Some of the less positive reasons for hiring consultants include

- The political end run – hiring a consultant to complete a project that a political enemy within the company is blocking.
- As a sacrificial zinc – hiring a consultant to take the blame for a failing project
- Easier to fire – hiring a consultant because consultants are easier to fire
- Money to spare – hiring a consultant because you have money at the end of the year
- May Day – hiring a consultant as a last ditch effort to avoid bankruptcy

As a consultant, you need to recognize these situations. Not all necessitate avoidance, but you do need to be aware of the possible outcome.

## Reasons for becoming a consultant

Most people would say that the main reason for becoming a consultant is to become your own boss. The majority of consultants (and contractors), however, work for consulting firms. Even many independent consultants work with one primary client on a long-term basis, which gradually simulates permanent employment.

So, although you do achieve more independence even within consulting firms, control may not be the primary issue. Consulting does usually offer a wider variety of projects, which I believe is one of the most rewarding aspects of consulting. Clients rarely want to pay consultants to support production code unless the upgrades are continuous.

If you are really good, you can probably make more money than in a permanent position, but you do assume slightly more risk. If you tend to work long hours anyway, charging by the hour can be very rewarding compared to an fixed annual salary. If monetary elevation is your only objective, you may want to reconsider leaving the corporate world.

If you thrive on hard work and enjoy satisfying people who need your help, you will be happy as a consultant.

## Managing the business: INCOME

Naturally, the first challenge in running the consulting business is generating income. Ideally, you can pick a reasonable rate and work all the hours you want (not more and not less). In this discussion, however, I will touch on income issues, but focus on expenses that emerge when you start operating a business.

In a consulting business, you charge for service rather than a product (at least in this discussion). Charges for consulting services fall into two general categories: time and materials or fixed-fee projects. Both approaches have their pros and cons and obviously you can mix the methods depending upon the situation.

## **Time and materials**

Charging by the hour or day offers a simple risk-free approach to consulting and is usually recommended for beginners. The challenge is setting your rates such that you do not price yourself out of the market, while still making enough to cover expenses and make a profit. With a little research and a good contract, you can easily match the salaries you make in the permanent employee world.

Hourly work is enticing because you can see an obvious return on every minute of work you complete. You are rewarded for hard work and long hours. Unfortunately it is easy to become immersed in the current contract work and miss the opportunities to secure the next project. Plan to look ahead and make sure you save some of your profits for the slow times between contracts.

## **Fixed-fee projects**

A fixed-fee project assumes that you will deliver a specified product or service for a mutually agreeable price and, in most cases, by a specified time. This type of project should involve a contract, which identifies all deliverables, delivery dates, and payment schedules. Be sure to hire an attorney before you sign a contract, especially for a fixed-fee job. The terms of these contracts come in all flavors, including those that penalize you for delivering late or withhold payment until the client accepts your deliverable.

The fixed-fee project can be rewarding, but to the beginning consultant who does not have experience estimating the magnitude of a project, it can be deadly. Most companies do not make their employees track the hours they spend on a specific task, so most people do not realize how much effort they expend on a task. As a result, new consultants tend to severely underestimate the hours it takes to deliver a final product.

Obviously, if you can work faster than everyone else, you can profit by bidding on fixed-fee projects. Be sure to account for client indecision, by providing a vehicle for changing the specifications. Changes and enhancements can be bid separately or on a time and materials basis.

## **Managing the business: EXPENSES**

Once you determine how to generate income, you need to learn how to keep it. Expenses arise in all kinds of surprising places and if you are not prepared, you will be committed to a project for an overall loss. Before you jump into business, find an experienced accountant or at least a good book and a well-known software package. Do not expect the average accountant to love your numbers the way you do, but you can expect them to identify the required taxes you must pay and avoid the expensive penalties and late fees you pay if you miss IRS deadlines.

Expenses can be grouped according to frequency of payment and level of variability. For example, expenses can be:

- Fixed and paid annually
- Fixed and paid monthly
- Per employee and paid annually
- Per employee and paid monthly
- Per employee per hour worked and paid monthly
- Variable or unpredictable

Obviously, these can be further reduced during budgeting and forecasting efforts by converting monthly to annual or annual to monthly. For this discussion, I will convert to annual figures. In addition, variable or unpredictable expenses will be lumped under fixed annual as budgetary estimates, but you will see that many could be tied to the number of employees and might therefore be placed under “per employee and paid annually”.

### **Fixed annual expenses**

Fixed annual expenses include charges such as permits and property taxes or costs that you need to budget or allocate with some discretion. Most of the items listed in this category can be tied to the number of employees. For example,

office rent is certainly a function of the number of employees you have, but, unless your growth is exponential, the costs are usually fixed within a year. Also, as your employee count rises, so should your gross income and therefore many of your annual expenses. For this discussion, however, assume that the items listed below are budgeted at fixed intervals.

Example fixed expenses include:

Office rent — If you work onsite or out of your home, you do not have to worry about this. Commercial rent can be a limiting factor to any business and is usually paid monthly.

Accounting — We have a fixed-fee contract with our accounting firm, but depending upon your accounting firm and what you ask them to do, you may choose to pay per hour or per employee.

Corporate insurance — Non-employee related insurance, such as general liability, automobile liability, employer's liability, error and omissions, etc. Many clients will require certain levels of insurance for the company, so plan on spending some money here.

Property tax — Taxes for business property, such as computers, copiers, fax machines, or commercial property. These are fairly predictable if you know your business.

Income tax — Taxes on income that is attributed to your company. These are usually passed through to your personal taxes unless you are a C corporation.

Permits/fees/dues, city and state work permits, annual membership dues, etc. — These are usually not too expensive, but do increase your paperwork.

Web site hosting charge — If you choose to place your Web site on an Internet provider's server.

Internet access — Usually a fixed monthly fee, which may change in the near future. We currently pay a fixed price for an ISDN line that provides unlimited access for all employees. If each employee uses a separate dial-up account, you must shift this to a per employee expense.

Software — Some software, such as SAS software, must be renewed annually. The cost of SAS is split between fixed annual and per employee expenses. In addition, you should estimate how much you are going to spend on other software additions and upgrades. Software for network servers, groupware, FAX servers, back up, and virus protection can get very expensive. Plan ahead. Again, if you work onsite, your costs here should be minimal.

Hardware — Cost for server hardware should be budgeted annually to keep pace with your growth.

Attorney fees — Use an attorney to write or review all of your contracts. Do not play amateur lawyer. Even if you find a reliable software package that provides a selection of sample legal documents, ask your attorney to check them for applicability in your state. Attorneys are expensive, but they might save you money and pain when you get to the end of a contract.

Marketing — Marketing is the hardest activity for "techie" to swallow, not to mention pay for, but be sure to allocate time and money for marketing as you grow.

Magazine subscriptions — business magazines or technical journals

Books — reference books that you purchase for the company library but not for each employee.

### **Per employee expenses**

Each employee imposes an overhead that is independent of the hours they work. Keep this in mind before you offer part-time employees full benefits.

Example per employee expenses include:

Software manuals and books — Technical manuals are necessary but not cheap, especially when you multiply each by the number of employees in your company.

Office supplies — Not a big concern unless you use a bunch of paper.

Retirement administration — We have a fixed-fee, per-employee contract with our retirement plan administrator, but you may prefer to pay per hour. Retirement benefits are a complex topic that will take much of your time to decipher,

if you decide to offer them. Save yourself the pain and contact a retirement specialist as well as an accountant. The penalties for improper administration are severe.

Medical insurance — Medical benefits deserve a completely separate discussion, so I will not go into detail here. Health insurance gets very expensive, so look for deals through professional organizations and research each policy thoroughly. Traditional insurance may soon be out of reach, so most companies are moving toward either a PPO or HMO type coverage. Watch out for companies that increase their rates dramatically after the first year.

Life insurance — Usually you can get a small policy attached with your medical insurance. If not, just shop around.

Disability insurance — Do not ignore this type of insurance. It can get expensive, but it is a necessary expense. Even if you do not provide the coverage for your employees, encourage everyone to get it individually.

Federal unemployment tax (FUTA) — The financial impact of these taxes are not as significant as the other payroll taxes, but should be considered.

State unemployment tax — Some states require payment of a tax similar to FUTA. Check your own state requirements.

Telephone charges — If you do not work at the client's site, the telephone is one of your most important tools. You will want each employee to have their own voice line and data line, so study your phone companies billing rates and plan accordingly. ISDN lines offer very enticing speed and quality, but charges vary from state to state and can be very costly. In addition, it can take months to get ISDN lines installed.

Education — If you want to keep good employees and provide the latest technology, allocate funds for training for each employee.

Conferences and travel — Whether it is for marketing or for education, you will want to send some employees to conferences. These can get expensive, so pick your conferences wisely.

Membership fees — Optionally, you may want to pay the membership dues for selected professional organizations.

Software — If your employees work at your office or at home, software can be one of your biggest expenses. By the time you load Microsoft Windows 95, Microsoft Office 97, SAS software, backup software, antivirus software, communications software, a graphics package, and a FAX client, you have a rather sizable investment in software for each computer you buy.

Hardware — If your employees work at home, hardware per employee includes computers, printers, modems, and UPS. Many companies provide excellent values on computers now, so get as much power and functionality as you can. To keep up with technology, you should plan on upgrading or replacing every 2 to 3 years and budget accordingly.

Administration — As the number of employees rises, you will find yourself loaded with more and more administrative responsibilities. If you started the company as the primary income generator, you may find this frustrating and costly. Get help wherever you can find it.

Prospect interactions — As you hire more employees, you will need more work, so you will also need to work with more prospects by fielding calls and letters that may not lead to real work. Whether you perform this task or you hire someone, prospect filtering and marketing become a necessary overhead.

Project estimation — Many potential clients will ask you to estimate the cost of completing a project, whether hourly or fixed fee. If you are not careful, you can spend many valuable hours bidding on projects for which you have no chance. Try to develop a efficient estimation process, so you can react fast and accurately. Estimation costs are insidious, because they are invisible but expensive.

Project management — As your company grows, you will need to spend more time on project management. Remember to incorporate project management into your project estimates, if the time is reasonable for the number of consultants on the team. Otherwise, project management becomes another category of overhead.

### **Per-employee, per-hour expenses**

If you pay your employees an annual salary, you can move the items below into the per-employee section, but we pay

per hour so we must calculate payroll appropriately. Payroll is probably the biggest expense you will encounter. So, before you set your clients' rates and your employees' pay rates, be sure to calculate all of the expenses listed above.

In conjunction with the salary, you will be required to pay payroll tax to the federal government and the state. Your accountant can save you plenty of agony figuring out deposit schedules and filling out quarterly reports. If you really must know more about this stuff, you can read Publication 15: Circular E, Employer's Tax Guide from the Department of the Treasury or connect to <http://www.irs.ustreas.gov> for access to all of the available tax forms from the IRS.

Example per-employee, per-hour expenses include:

Salary — If you pay by the hour, you simply calculate the salary as number of hours times the pay rate. Remember that you may encounter times when your employees want to work, but you do not have billable work ready to start. In this case, you will be paying salaries which are not offset by income.

FICA (Social Security) — As an employer, you must withhold and deposit 6.2% of your employees' salary and you must pay and deposit an additional 6.2% of your employees' salary for social security tax. This tax applies only to the first \$65,400 earned per employee per year.

Medicare — As an employer, you must withhold and deposit 1.45% of your employees' salary and you must pay and deposit an additional 1.45% of your employees' salary for social security tax. All wages are subject to the tax.

Retirement plans — Retirement plans come in many flavors. We offer a 401K profit sharing plan. The company strives to contribute a minimum of 10% of each employee's salary each year. In addition, the employee can contribute additional amounts through payroll deferrals. If you want to contribute to the employees' plan, be sure to include this contribution in all of your budgeting efforts.

Bonuses — If you decide to pay your employees bonuses, remember that the IRS views a bonus as salary. All payroll taxes and profit sharing percentages apply to all bonus amounts.

Vacations — If you offer paid vacations, remember that you are not only paying salaries for that time, but your company is not making any money.

Income tax withholding — Although you do not pay the withholding tax out of your budget, make sure you withhold it and deposit it on time.

## **Summary**

As you can see, running a business can be complicated, especially when you hire employees, offer benefits, and maintain an office. Although I did not list specific dollar figures for each of the expense items, I hope the list will at least guide you in your research so you can fill in the blanks for your situation.

Using these factors for income and expenses, you can formulate equations to determine clients rates or employee rates as a function of hours worked. Or conversely, determine the minimum acceptable number of hours that a specific employee should work in order to stay profitable.

Working at the client's site may provide the simplest path to starting your own consulting business, but you must decide what type of lifestyle you want. If you watch your expenses and provide quality service, your consulting business can be very successful. It is not, however, an easy path, so make sure you enjoy the work and the lifestyle before you commit.