Overhead – an alternative view

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This is the first part of a two-part article, the remainder of which will appear in the Winter '06-'07 issue of Oregon Architect.

FOR AS LONG AS MANAGERS, LEADERS, COMPILERS AND ANALYSTS OF DESIGN FIRMS have looked at the business and practice aspects of their firm, the overhead to support them has averaged within 10 percent of 1.50, meaning that it takes 150 percent of every direct (project specific) labor dollar to support that direct labor. The actual range of overhead–in firms other than those operating in a spare room–is extensive, varying from 0.80 and to others as high as 2.50. What will a careful analysis of overhead reveal? Are firms supporting their direct labor appropriately? Are they putting appropriate energies and time into leadership? Are they putting energies, time and resources into marketing, management, administration and technology, and the resources that support each? In short, are firms using their overhead to help them excel toward however they measure their success?

How important is the overhead? One can legitimately conclude that the success of a firm hinges heavily on the quality of its work (largely a function of its talent), the satisfaction and value it provides to its clients (largely a function of how well it understands its clients and the process by which it engages its talent to produce quality "product" and service), and the profitability that results. The strength of its leadership and its culture, the availability of the right resources, and the ability to achieve *alignment* of talent, clients and resources are all catalysts toward these ends. So what does overhead have to do with it?

Consider an "Average Firm" and a "High Performing Firm," both of whose financial indicators appear in Table 1.

The High Performer profile is a very real firm whose financial performance is admirable at any size (and more likely to be seen in practice of 10 to 15 people). That the firm has a staff of over 40, that it does highly respected work, that it has very high client retention and that this performance is somewhat consistent from year to year make the performance somewhat incredible. A line-by-line commentary on the data might provide some learning and applicability to other practices.

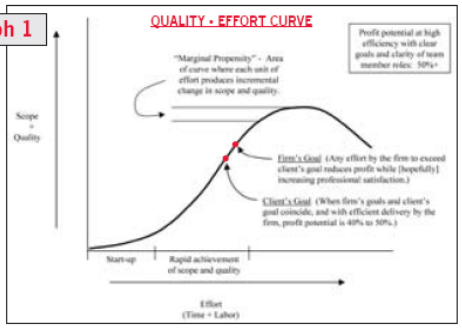
First some overall observations:

1. The High Performer, like most highly profitable firms, is *practitioner-led*. Its leaders are hands-on architects with:
   - heavy roles in project strategy development, working closely with clients;
   - conceptual and schematic design roles;
   - client leadership and client relationship roles; and
   - marketing and selling roles.
2. Like most highly profitable firms, staying close to and serving clients is a priority, with resulting benefits to the clients being the greater understanding that team leaders and team members have about each client's philosophy, strategy and people.
3. Like most highly profitable firms, demand for the firm's services requires that it deliver in short time frames, leaving little time to lose money, while also compelling project teams to "get it right" the first time.
4. The firm's prevailing attitude, which has served it well since its founding, is to do really good work with an obsession for service and let other things fall into place, with tremendous oversight by the firm's leaders.

Table 1

		Average Firm	High Performing Firm
a.	Gross revenue [as factor of net revenue]	1.30	1.30
b.	Net revenue [as factor of net revenue]	1.00	1.00
c.	Direct labor [as factor of net revenue]	0.31	0.22
d.	Indirect labor [as factor of net revenue]	0.18	0.04
e.	Non-labor overhead [as factor of net revenue]	0.31	0.14
f.	Total overhead [as factor of net revenue]	0.49	0.18
g.	Total expenses [as factor of net revenue]	0.82	0.40
h.	Operating profit [as factor of net revenue]	0.18	0.60
i.	Utilization [direct labor / total labor]	0.64	0.84
j.	Direct labor multiplier [net revenue / direct labor]	3.23	4.54
k.	Overhead factor [total overhead / direct labor]	1.58	0.82

Graph 1



Specifics based on the data:

1. Gross revenue is largely irrelevant when considering a firm's financial performance, as is the relationship between gross and net revenues. For those to whom "bigger is better" prevails, talking about gross revenue might feel good, but that's the only benefit.
2. Net revenue is what remains after deducting reimbursable consultant expenses, other reimbursable expenses, direct (non-reimbursable) consultant expenses and other direct non-labor expenses.
3. The direct labor as a function of net revenue is the inverse of the direct labor multiplier in item "j" in the table above. The lower the number in item "c" in that table, the higher the direct labor multiplier, which results from a combination of three things: perceived value, skill in fee negotiations and efficiency in delivery of the work. The difference between the Average Firm and the High Performer is noteworthy. The High Performer firm delivers its work with about 70 percent of the effort (relative to net revenue) of the Average Firm (.22/.31= 71%). How?
   a. It starts projects with more clarity about the goals, roles and game plan for delivery. The graph (see above) indicates the critical importance of this "start-up" phase in a project process.
   b. It adjusts more quickly when a project appears to be going sideways.
   c. It relies more on developing teams with the ability to do the work well and not rely on outside eyes to assure quality. The result, which generally is *not* an acceptable model for firms with a wide variety of project types and/or a high percentage of relatively inexperienced staff, is that quality control-related overhead is minimal.
4. The indirect labor reflects non-project labor to support the direct labor efforts and the firm in general. Indirect labor is usually the biggest single category in a firm's overhead, so it is no surprise that it is the first thing at which to look when trying to lower overhead. Reducing indirect labor not only reduces the overhead, but at any given total labor level, a reduction in indirect labor increases the *direct* labor, and if the direct labor brings value to projects–in other words, if labor is applied productively–it increases the profitability. The High Performer's remarkably low indirect labor results from several factors:
   a. One, as noted above, is the low level of overhead oriented to controlling quality.
   b. Another is the low labor for marketing, the result of high client satisfaction, with clients returning and also referring other clients to the firm. The net effect is that the firm responds to inquiries, an approach that serves it well as long as those inquiries are from clients it wants to serve.
5. The *non-labor* overhead is the cost of non-personnel resources–such as rent, technology, insurance and supplies–about the only widely consistent component of which is occupancy, which includes rent or (amortization), utilities, repairs and maintenance. Occupancy within the architecture profession hovers remarkably close to 5 percent of net revenue, irrespective of size, complexity and location. ■

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