

Overhead – an alternative view

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This is the second part of a two-part article. The first part appeared in the Fall 2006 issue of Oregon Architect.



Hugh Hochberg

A MORE DETAILED LOOK AT OVERHEAD IN AN Average Firm reveals the following, with all labor items expressed in terms of raw labor cost and all items expressed as factors of net revenue:

1. Indirect labor is the largest line item comprising about one half of the total overhead and about 18 percent of net revenue.
2. Marketing expenses account for about 5.5 percent of the gross revenue – which, for a firm whose net revenue is 70 percent of its gross revenue, equates to about 8 percent of net revenue – of which about 70 percent is labor at raw labor cost, equaling 5.5 percent of net revenue and 30 percent is non-labor, equaling about 2.4 percent of net revenue.
3. Technology costs – hardware, software and training – about \$3,300/year per person when calculated as a three-year running average, which equates to 2.9 percent of net revenue.
4. Management labor averages about 10 percent of total labor, equating to 5 percent of net revenue.
5. Accounting and financial management labor equate to about 5 percent of total labor, or about 2.5 percent of net revenue.
6. Technology labor – the labor to support technology throughout the firm – typically totals about 3 percent of total labor, equating to about 1.5 percent of net revenue.

7. Administrative labor averages about twice the management labor, or 10 percent of net revenue.
8. Because occupancy so consistently hovers around 5 percent of net revenue in all economies, locales and firm types, it is difficult to envision how such costs might be reduced (if the model is built around market rate pricing of space).

Exploring how to achieve better overall results of the practice with different approach to overhead might look like this, referring to the items noted immediately above.

1. Reduce the indirect labor in general by employing it more judiciously, with examples noted in subsequent points below.
2. Increase the effectiveness of marketing efforts and expenses through such means as ...
 - a. defining with greater clarity criteria of the “right” clients and projects to pursue, thereby eliminating time on inappropriate pursuits
 - b. identifying client-centered media and events that allow more marketing focus
 - c. honing communication, proposal-writing and presentation skills to increase effectiveness of selling efforts
 - d. capitalizing on software to increase efficiency of maintaining marketing information
 - ...all of which might lead to net reduction of marketing labor of about a third and of marketing non-labor expenses of about 20 percent, for a total reduction to about 4 percent of net revenue.
3. Technology costs, particularly in light of the rapidly evolving design and delivery software (notably building information modeling and its derivatives), will need to continue at current levels to allow a thriving practice to benefit from the technologies’ capabilities.

4. Management labor is largely a consequence of complexity and perceived complexity in the firm, with perceived complexity increasing as organizational leadership effectiveness diminishes in such key areas as clarity and communication of values, vision, goals and expectations. Organizational management needs also

increase as project-specific leadership declines in effectiveness. The obvious and correct conclusion is that stronger leadership at the firm and project level reduces (but does not eliminate) the effort that must go into management. Such leadership strengthening can reduce management by 50 percent to about 5 percent of net revenue.

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TABLE 1

	Average firm	Alternate overhead with higher revenue/person
Number of personnel	20	20
Net revenue	\$2,419,200	\$3,265,920
Direct labor	\$ 806,400	\$ 907,200
Overhead labor	\$ 457,934	\$ 698,141
Overhead non-labor	\$ 751,666	\$ 674,654
Total overhead	\$1,209,600	\$1,179,360
Operating profit	\$ 403,200	\$1,179,360

Notes:

1. The overhead labor increase in the second column results from higher training and development expenses, which more than offsets the lower marketing labor.
2. That the total overhead equals the operating profit in the second column is purely coincidental.
3. These data reflect certain expenses that are normally expected to vary with net revenue – such as occupancy and marketing – relating instead to direct labor. Stated differently, and using occupancy as an example, if it cost \$6,000 in occupancy for a person for a year, that is the cost irrespective of the revenue that person generates.

TABLE 2

	Average firm	Alternate overhead with higher revenue/person
Marketing labor	.042	.027
Accounting & financial mgt labor	.030	.022
Technology labor	.010	.008
Administrative & miscellaneous labor	.025	.019
Training and development labor	.005	.015
Leadership and management labor	.035	.026
Vacation, sick, & holiday labor	.042	.031
Sub-total – overhead labor	.189	.147
Marketing non-labor	.018	.018
Technology	.017	.012
Occupancy	.050	.037
Other non-labor overhead	.213	.209
Sub-total – overhead non-labor	.311	.214
Total Overhead	.500	.361
Other indicators:		
Utilization	.064	.072
Direct Labor Multiplier	3.000	3.600
Overhead factor	1.500	1.300
Operating Profit	.167	.361

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5. Better use of financial management systems and higher accountability on the part of project managers can reduce accounting and financial management labor by 20 percent.

Consider a firm with raw summary data as it appears in the first column, and compare it with the firm whose data is in the second column (see Table 1).

A summary of overhead categories as components of net revenue is illustrated in Table 2.

The profitability as a function of revenue in the second column more than doubles that of the first column. When converted to dollars, the increase is compelling (increasing by \$776,160, from \$403,200 to \$1,179,360). However, it is misleading to look at changes in overhead only as a function of net revenue, since the "alternative approach" results in higher net revenue, which in fact is a bigger factor in the increased

profitability than are the overhead changes by themselves.

Not all firms are likely to be willing to make these kinds of adjustments because in some cases the changes confront people with the notion that what they do and/or how they do it might need to differ considerably from the present. Other firms, perhaps convinced that the *status quo* is acceptable, shouldn't try. But for those firms whose leaders question the value of their overhead as currently structured, there is ample opportunity to change, with possible results being more efficient use of overhead, lower overhead cost, higher quality, greater value provided and higher profitability. Not bad results for firms willing to challenge the profession's, and their own, conventional wisdom. ■

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