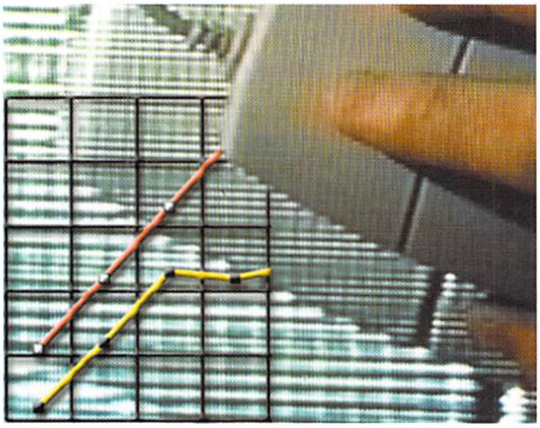
Calculating Overhead to Determine Profitability

By Paul Sullivan



Can you truly measure how much each lawyer costs your firm and how much profit he or she generates? Here's a guide to getting an accurate cost/revenue picture.

I'm often asked how to determine overhead, and specifically how to calculate "overhead per attorney." It's not a simple task, particularly in a firm with several attorneys, some of whom use more resources than others. Simply dividing total expenses by the number of attorneys won't provide an accurate number. The perfect method would be to break down every expenditure and allocate it to each attorney on a prorated basis, but the administrative cost of this approach outweighs the benefits.

The best approach, then, is to create a system that allocates overhead in a fair and consistent way but isn't overly difficult to administer. If designed correctly, this system will show the profitability of each revenue producer and give you a benchmark to compare your operation with others in your line of practice. It will also help you determine whether your rates need adjustment and, most importantly, will give you meaningful guidelines for setting compensation.

Direct and indirect overhead

Where do you start? Most lawyers use a flawed system, determining overhead to be all expenditures other than the compensation of the owners. As a result, the overhead figures from firm to firm vary greatly, making it impossible to compare one firm to another. Consider this – if associate salaries are part of the overhead, then the simple way to reduce overhead is to make all the associates owners.

To properly calculate overhead, you must include each timekeeper – i.e., each employee who generates billable hours – in the determination, including paralegals. There are two types of costs, direct and indirect. Direct costs are expenditures you can directly relate to an individual timekeeper – salary, payroll taxes, benefits, memberships, anything you can fairly and accurately allocate to a timekeeper. An example is life insurance premiums, where costs vary from person to person based on age and health.

Indirect costs are everything else – occupancy expenses, support staff salaries, equipment costs, and the like. Once you have determined the direct costs for all revenue producers, subtract it from total revenues to calculate indirect costs.

You then need to develop a system for allocating indirect costs to each timekeeper. How? Not by dividing total indirect costs by the number of timekeepers, which is easy but not very accurate. The most common approach is to weight direct overhead for each timekeeper based on an analysis of the percentage of total resources a timekeeper consumes.

For example, a partner requires more support from staff – document preparation, computer usage, copiers, travel, etc. – than an associate, and definitely more than a paralegal. This is a subjective area, but analysis of billable hours or just an educated guess is a place to start. Typical weighting might be as follows – 1.5 for a partner, 1.25 for a junior partner, 1.0 for an associate, and .5 for a paralegal. An attorney who has a full-time secretary would receive a greater weighting than one who shares a secretary. Weightings could be tweaked over time to yield an even more accurate system.

Once the weighting is assigned, the total for all timekeepers is divided into the indirect cost to arrive at per-unit overhead. This figure is then multiplied by the weighting for each timekeeper to arrive at the indirect cost per attorney.

Examples

Here's an example of allocating indirect costs using two different weighting approaches, illustrated in Figure 1 (see next page). Allocation method B requires you to make some assumptions about individual firm members but arguably produces more accurate results.

Allocation Method A. ABC Firm is composed of two partners, two associates, and one paralegal. In allocation method A, each partner is assigned a weighting of 1.5, the associates 1.0, and the paralegal .5. Total firm indirect costs are $110,000. The allocation would then be made by dividing

Figure 1

Allocation A	Indirect Costs	Allocation B	Indirect Costs
Partner A - 1.5	30,000.00	Partner A - 2.0	32,592.60
Partner B - 1.5	30,000.00	Partner B - 1.75	28,518.50
Associate C - 1.0	20,000.00	Associate C - 1.50	24,444.45
Associate D - 1.0	20,000.00	Associate D - 1.0	16,296.30
Paralegal - .5	10,000.00	Paralegal - .5	8,148.15
Total - 5.5	**110,000.00**	**Total - 6.75**	**110,000.00**

$110,000 by 5.5 to reach a unit indirect overhead allocation of $20,000 per timekeeper.

Allocation Method B. In XYZ Firm, one of the two partners is recognized to be more productive than the other, and one of the associates has been around awhile and the other just started. Consequently, the weighting has been changed. The expense numerator remains the same, but the total allocation denominator now changes to 6.75, yielding a unit cost of $16,296.30.

Total cost is then determined by adding the indirect cost for each timekeeper to that person's direct costs. Deduct the total cost from receipts allocated to that timekeeper, and you arrive at the contribution to overhead or profitability each timekeeper makes.

One additional factor worth considering is the current accounts receivable balance (bills yet unpaid by the client). Because this analysis focuses on a specific time period, the arrival and booking of receipts could have a big impact on any given individual's profitability.

A sharper focus on profitability

The example continues in Figure 2. We will use allocation method B to break out costs and actually make a "profitability" calculation, a powerful tool for determining the productivity of each firm member. *All figures are for illustration only and not to provide representative ratios of expense to revenue.*

Using associates to produce more revenue than their total cost is called leverage. Successful firms will use leverage to fund additional income to the owners. That produces an allocation in which the owners show minus profitability, but only because of their additional direct cost, which is their personal income. An allocation breakdown that shows two partners producing the same revenue with disparate profitability could lead to some interesting compensation discussions.

As a matter of good business practice, every firm needs a reasonably accurate overhead-per-attorney figure. Although creating such a system requires effort and continual adjustment, it can provide information vital to making sound business decisions.

Interestingly, obsession with expenses and indiscriminate expense reduction is not the key to profitability. Expense management, along with a sound plan to increase revenue, is the key. Standing alone, every dollar you cut in expense makes it harder to deliver satisfactory service to your client. But every dollar increase in revenue gives you more resources to market your services and provide world-class service to your clients. ■

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Figure 2

Attorney	Receipts	Direct Cost	Indirect Cost	Total Cost	Profitability
Partner A	175,000.00	150,000.00	32,592.60	182,592.60	(7,592.60)
Partner B	160,000.00	135,000.00	28,518.50	163,518.50	(3,518.50)
Associate C	110,000.00	75,000.00	24,444.45	99, 444.45	10,555.55
Associate D	60,000.00	35,000.00	16,296.30	51,296.30	8,703.70
Paralegal	15,000.00	27,500.00	8,148.15	35,648.15	(20,648.15)