Calculating Billable Ratios

Contributed by Douglas Robertson, AIA

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SUMMARY

Douglas Robertson, AIA, explains the importance of watching and monitoring fluctuations in your billable ratio. Major fluctuations or a low ratio could signify decreasing profitability. The calculations necessary to adequately identify a firm's billable ratio are presented below.

THE BUSINESS CASE FOR CHECKING YOUR NUMBERS

Every industry has one or two "essential metrics" that a company must get right just to stay in business. An individual firm may have additional measures particular to its market. In the architecture trade, one figure that must be on target is the billable ratio. Every profitable firm has an innate understanding of this measure. Likewise, anyone who has ever been surprised by going out of business has either forgotten or never learned how to calculate and use this deceptively simple metric.

HOW TO CALCULATE THE RATIO

How do you calculate your billable ratio? First, you must identify *direct labor cost* and *total labor cost*. One way to determine direct labor cost is to add all the payroll expenses that appear when an employee is hired and disappear when one leaves. For example, health insurance premiums, vacation days, and payroll taxes all track closely to employees, so they are direct labor costs. Office space, telephones, and utilities have a bigger time lag and are better considered as overhead expense.

Your direct labor cost is the number of billable hours multiplied by their cost per hour. You cannot count certain things in this ratio: unpaid work (such as competitions, pro bono work, and contingent projects that do not pan out). To gain a realistic sum, it is important not to fudge the numbers here.

A PRACTICAL EXAMPLE

For example, let's say your firm consists of two principals, two recent graduates, and a receptionist. First, total everyone's time cards from the week. For each person in the firm, add up a quick "running total" of billable and nonbillable hours. Once you've done this, you'll know three things:

- The total number of payroll hours (A)
- The total number of hours you'll be paid for (B)
- The number of hours you've paid for out of pocket that you could not sell to a client (this is too depressing to give a variable name to)

Now divide: B/A. Your sum should be somewhere between 0.65 and 1.0. The closer to 1.0, the better.

This is your billable ratio in terms of hours. It should also be pretty close to your billable ratio in terms of dollars. To check, repeat the steps you took for the firm as a whole for each employee and partner individually (i.e., see how much each person costs in terms of billable and nonbillable hours). Then, add up the "billable dollars" and divide by the total. If you go this route, include direct payroll expenses such as workers' comp or any local payroll taxes that may not show up on your monthly payroll report.

HOW DOES THIS CALCULATION HELP?

The firms that survive the next downturn will have many differences but one thing in common: They will watch their billable ratios as work slows down. This measure is the place where the financial and project-related management aspects of architecture most clearly intersect.

How? First, you have to recognize that in the design business, there's always plenty of work. That's easy. The hard part is getting and then focusing on the work you actually get paid for. If you watch this number on a "trend" basis, it can quickly tell you whether the firm is busy doing paid work or whether you're spending too much time on nonproductive tasks (e.g., uncompensated competitions).

Second, payroll costs will be, by far, your biggest expense. If you have a good sense of your billable ratio, you can come up with a real overhead number when you're proposing a project. It may not be desirable to think with a low-bid mentality, but let's face it: Economics is part of the equation in winning and losing a commission.

ABOUT THE CONTRIBUTOR

Douglas Robertson, AIA, is principal and CEO of House and Robertson Architects in Los Angeles. This article originally appeared in *Practice Management Digest*, eNewsletter of AIA Practice Management Knowledge Community. It has been adapted with the author's permission.

RESOURCES

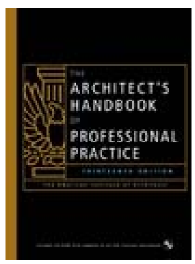
More Best Practices

The following AIA Best Practices provide additional information related to this topic:

08.01.02 Starting a Firm: Essential Financial Vocabulary

08.03.01 Financial Management: 10 Key Performance Indicators

For More Information on This Topic



See also "Financial Systems" and "Financial Planning" by Lowell Getz, CPA, and "Financial Health" and "Acquiring Capital," by Peter Piven, FAIA, *The Architect's Handbook of Professional Practice, 13th edition*, Chapter 8, pages 183, 194, 203, and 214, respectively.

See also the 14th edition of the *Handbook*, which can be ordered from the AIA Bookstore by calling 800-242-3837 (option 4) or by email at bookstore@aia.org.

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