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Billable Ratios: Architect's Little Helper

by Douglas Robertson, AIA

So you've moved out of the garage, rented a small office, and even hired a few employees. It's 8 p.m. and you're about to wrap up your day job as architect and start your night job as small business person. Someone has to pay the water-delivery person and rent and send the invoices. And at some point, you need to figure out if you should hire that super smart kid you talked to today or if you need to tell your staff they should probably start getting their resumes in order. If you're wishing you hadn't slept through that professional practice class, don't worry. They didn't tell you about any of this stuff anyway.

Every business has one or two "essential metrics" that a company has to get right just to stay in business. Many additional measures will be particular to your firm or market. But in the architecture trade, one figure you have to get right is the billable ratio. Every firm that has managed to stay profitable and, hence, stay in business, has an innate understanding of this measure. Likewise, anyone who has ever been surprised at going out of business has either forgotten or never learned how to calculate and use this deceptively simple metric.

Calculating the ratio

So how do you calculate your billable ratio? Tally up your direct labor costs and divide the sum by your total labor cost. If your sum is more than .65, your firm should be okay. If your sum is less than that, you may soon have some uncomfortable conversations with the bank.

> **Tally up your direct labor costs and divide the sum by your total labor cost**

The simplest way to do your tally is to add all the payroll expenses that appear when an employee is added and disappear eventually when one leaves for whatever reason. So, for example, health insurance premiums, vacation days, and payroll taxes all track closely to employees. Office space, telephones, and utilities have a bigger time lag and are better considered separately as a different type of overhead expense.

Your direct labor cost is the number of hours, and their cost, you were actually able to bill for. Some things you cannot count in this ratio: unpaid work (like competitions, pro bono work, and contingent projects that do not pan out). To gain a realistic sum, it is most important you do not fudge the numbers here.

Here's a practical example

Let's say we have a startup firm consisting of two principals, two recent graduates, and a receptionist. First, collect the time cards you've been completing every week. For each person in the firm, add up a quick "running total" of billable and nonbillable hours. Don't fudge this; you're not going to share this information with anyone, and you don't want to inadvertently fool yourself. Once you've done this, you'll know three things:

- The total amount of actual hours you've paid for (A)
- How many hours you've been paid for (B)
- How many hours you've paid for out of your own pocket that you were not able to sell to a client (this is too depressing to give a variable name to).

Now divide: B/A. Your sum should be somewhere between .65 and 1. The closer to 1 the better, of course.

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

> **Don't forget to include direct payroll expenses such as worker's comp**

Why you should care

Good times never last forever. The firms that survive the next downturn will have many differences and one thing in common: they watched their billable ratio as the work slowed down. Finally, 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 that you can actually get paid for. If you watch this number on a "trend" basis, it will quickly tell you that you really are busy doing paid work (if the number trends down) or you're spending too much time on nonproductive tasks (e.g., uncompensated competitions). Second, payroll costs are going to be by far your biggest expense. If you have a good sense of your billable ratio, you can come up with your 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.

Reference:
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