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## Better Management Control in the Professional Office

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*Planning and control of business procedures are all too often badly neglected in professional practice — the attorney's, architect's, or even the management consultant's office. Some corrective measures for —*

## **BETTER MANAGEMENT CONTROL IN THE PROFESSIONAL OFFICE**

*by Reginald L. Jones and H. George Trentin  
Arthur Andersen & Co.*

**T**HE TECHNIQUES of planning and control needed to keep a professional firm operating profitably and effectively are much simpler than those required to manage a business enterprise. Yet they are all too seldom applied. In many architectural, engineering, law, medical, and other firms engaged in selling professional services the way in which the practice is administered is a hindrance rather than a help to its progress.

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Unlike a business executive, the typical professional man has not been prepared by education or experience to consider management important or interesting. His interest is in his own field; his mission is to serve his clients; and often he has difficulty meeting all the demands on his time. His normal tendency is to consider administrative systems and procedures necessary evils. Often the result is neglect of the business affairs of his firm.

This situation presents a real opportunity for the CPA who serves as the professional firm's accounting advisor to be of genuine service, to move beyond the bookkeeping and billing systems to design an effective management control system for

the client. The basic principles outlined in this article have evolved from our own firm's consulting assignments for professional clients. They are applicable to all organizations providing personal services (even to consulting and accounting firms themselves).

### **Symptoms of trouble**

Many professional firms have grown substantially in size in recent years. From the firm's point of view such growth is generally considered desirable, but it poses problems in the management of human effort. A small practitioner keeps informed of his firm's activities without conscious effort, through personal observation and involvement. Once a

group of professional men reaches a certain size, however, no one man can give personal attention to everything, and the management process must be formalized.

A classic example of the communication problems that growth produces is the law firm that unaccountably finds itself representing both parties to an impending litigation. Most of the problems of growth are more subtle, although they may be equally devastating to a firm's reputation and chances for continuing prosperity. Every professional firm should be on the alert for the appearance of the following symptoms of the need for better management, often found even in firms showing good current profits:

**Vague objectives**—Every firm that plans to continue in profitable practice must have objectives, formulated and expressed in financial, operational, and manpower terms. Then the investment and its expected returns, the scope of operations, and personnel levels can be planned with a purpose. The absence of such objectives often becomes apparent in the absence of guidelines for directing activity toward results that are both desirable and reasonably attainable.

**The absence of a uniform fee policy and a fair fee structure**—Professional fees can be set in many ways. For example—just to mention two possibilities—an architect may have a contract for time-card cost plus profit, or a lawyer may charge on a statutory or court-approved fee basis. Regardless of how a particular client's fee is negotiated or arrived at, however, for management purposes a fee structure should be established as a benchmark for controlling performance and profitability.

### Productivity and profits

**Poor or uneven utilization of professional personnel**—It is obvious that failure to control the productivity of personnel can affect profits directly. Less obvious are the effects on morale, on turnover, and on the competitiveness of fees.

**Unreasonable overhead costs**—Overhead cost control is particularly important in professional firms because many overhead or support costs tend to grow disproportionately with professional activity. Accordingly, management must guard against the growth and persistence of an unreasonable overhead cost level that drains away profits.

**Poor control over the flow of cash**—Experience has shown that the impact of management control on cash flow is most crucial in the areas of billing and of manpower utilization. With a manpower table given, expenditures for payrolls, rent, and other overhead items are relatively easy to anticipate. The timing and amount of cash revenue, however, must be well controlled, starting at the point where professional personnel actually perform client work. Every hour of such work creates a potential asset of unbilled charges; whether these charges are earned or are not earned on any given day is a function of manpower utilization. The cash realization of such unbilled earnings potential then becomes a function of billing control.

Any or all of these symptoms spell potential danger for the professional firm. What is needed is a management control system that will expose—and point up corrections for weaknesses.

### Key elements of control

In a professional firm, as in a business, management should identify and control those factors in its economic activity which, either on

an individual or a group basis, have the greatest impact on profit. The system should be designed to measure these key management control factors clearly and objectively.

In professional work, management control centers around the value of the professional man's time and talent. In this article the use of time and talent is considered in five steps, as follows: the utilization of personnel, the worth of talent, the ability to bill for services, the investment in unbilled and billed charges, and acceptance of work.

### Utilization of personnel

Adequate control over the use of personnel is fundamental to profitable professional work. This is because time is both limited and dynamic; the hour lost today is never recovered. Conversely, the hour spent on client business by a professional man creates revenue potential and is, therefore, the source of future billings.

Time spent on client work may be classified as chargeable time and time not spent on chargeable work as a burden or overhead cost to the firm. Actually, this is exactly what happens, because professional men are paid or take drawings over an interval of time that encompasses a certain number of available hours for work. If those available hours are used on client work, the time used is assumed to be productive; if not, it is nonproductive or a form of overhead cost.

Control of productivity starts with the maintenance of adequate time records. Time-record-keeping



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Hrs.	Qtr.	Chargeable Time	Client	Matter	File No.	Date	Initials	
	1	Phone call	X-Cell Zine, Inc.	Merger with Giant Corp.	627	6/2/68	J. D.	
		Court time						
2	3	Travel						
1	-	Conference						
		Research						
Other (explain)								
Hrs.	Qtr.	Chargeable time	Client	Matter	File No.	Date	Initials	
		Phone	Ajax Corp.	General Corporate		6/2/68	J. D.	
		Court time						
	2	Travel						
	2	Conference						
		Research						
			Other - Consultation with S. E. C. re - 10-K					
						Cab fare	1 25	
Other (explain)								
6	-	Total chg. - this pg.	DAILY TIME SUMMARY			Tot. exp. - this pgs.	1 25	
6	-	Total chg. - other pgs.				Tot. exp. - other pgs.		
6	-	Total chg. - day				Tot. exp. - chg.	1 25	
1	-	Office management						
		Charity						
		Promotion						
		Director activities						
		Professional development						
		Vacation, holiday, illness						
1	-	Held billings	Held billing - A. B. Clark Corp. 1 hr. conference					
		Lost time						
1	-							
1	-							
2	-	Total nonchargeable (day)	Group	Corporate	Approval Signature		Tot. - nonchg. exp.	2 -
8	-	Total hours	Page No.	1/1	John Doe		Tot. - all exp.	3 25
1	-	Overtime hours	Date	6/2/68				

EXHIBIT I

involves both the individual and the firm's accounting department. The individual is responsible for an accurate account of the use of his available hours, and the accounting department is responsible for summarizing such time for each client engagement in progress and by category of nonchargeable time.

Every professional man in a firm should account periodically for all of his time during normal working hours whether spent on client matters or on nonchargeable activities such as administration, promotion, and professional development. Chargeable time worked after normal hours should also be reported because the firm should have a complete record of work done on client and other projects as well as of total hours worked by employees and partners.

The original record of this time is often a personal diary, in which entries are made each day. The information should then be recapitulated on a time sheet at regular intervals; the time sheet serves as

the accounting record for book-keeping purposes.

Exhibit I on this page shows an individual time sheet used by a law firm. In this example, the smallest unit of time recorded is a quarter-hour. The file number identifies the client engagement. Note that the form provides for the recording of expenses as well as of time.

This time sheet was designed for use in a manual accounting system and thus is provided with perforations for separation and sorting of client charges. Note that the sheet has two basic sections: the client data and a daily time summary. The summary provides data for calculation of a chargeable time ratio and for distribution of nonchargeable time by activity. Summarization of the daily time data is facilitated by the use of a peg strip, for which holes were provided.

The purpose of the timekeeping procedure is not only to provide billing information for those engagements to be billed on the basis

of time spent but also to inform the firm about its total cost of providing services on any engagement. Among other benefits, this knowledge could help the firm in its future fee negotiations.

Nonchargeable time covered

Another purpose served by this time-reporting procedure is to enable the firm to review and control the nonchargeable time of its personnel. Certain nonchargeable activities—such as promotion of new business—are appropriate at the higher levels of the firm but usually not at the lower levels. It is important to know who charges time to promotional activities and under what circumstances.

Also, instances may arise where individuals wrongly decide that time worked for a client is to be charged to a training category rather than to the client's account. It is important to be able to identify and rectify these mistakes in time reporting. In addition, where indi-

ASSOCIATED ARCHITECTS AND CO.  
SUMMARY OF CHARGEABLE RATIOS

June 19\_\_

Current Month

Hours:	Description	Current Month				
		Total Firm	Principals and Project Mgrs.	Design	Drafting	Specification Writing
	Total reported	4,576	704	528	2,640	704
	Vacation/holiday	480	160	80	200	40
	Available hours	4,096	544	448	2,440	664
	Chargeable hours	3,296	260	324	2,080	632
	Chargeable ratio — actual	80.4%	47.7%	72.3%	85.2%	95.1%
	Chargeable ratio — budget	84.9%	60.0%	80.0%	90.0%	90.0%
	Better (worse) than budget					
	Chargeable ratio	( 4.5%)	( 12.3%)	( 7.7%)	( 4.8%)	5.1%
	Chargeable hours	( 182 )	( 66 )	( 34 )	( 116 )	34
	Per diem value	(\$5,010 )	(\$2,640 )	(\$1,700 )	(\$1,160 )	\$510
	Overtime hours	300	10	—	270	20

EXHIBIT 2

viduals are working overtime, it is important to understand why that may be necessary and to determine its propriety in view of the nature and amount of time associated with nonclient work in the same period as the overtime. Finally, a review of time reports and information regarding nonchargeable time is an important check on the firm's personnel supervision, for it is a basic management responsibility to maintain the planned level of chargeable time and possibly to adjust the size of the staff to control the overall level of nonchargeable time.

A convenient way to measure chargeable and nonchargeable time is through a chargeable ratio—the ratio of an individual's chargeable hours to a standard measure, perhaps 40 hours a week, or to total hours worked. In addition to computing individual chargeable ratios, it is often useful to compute a combined chargeable ratio for a department or working group or for each level of responsibility in the firm, from principals through juniors.

Exhibit 2 on this page shows a summary of chargeable ratios in an

architectural firm. Note that the report is structured by department, not by project. The organization of this firm includes design, drafting, and specification-writing departments, each with a man in charge. A fourth departmental category includes principals and project managers.

The key control provided in the report is based on the budgeted chargeable ratios. For example, the ratio is lower for principals and project managers—60 per cent—than for drafting work—90 per cent. The budgeted ratio becomes a standard of performance required if the firm is to achieve the expected level of profitability.

To follow through our example, let's consider the drafting department, where the budgeted performance is 90 per cent of available hours. During June actual performance was 4.8 per cent below the standard. This is equivalent to 116 hours of nonproductive time that should have been productive if standard performance had been met. In this firm the billable value of a drafting hour is \$10; accord-

ingly, the loss in potential fee revenue is \$1,160 with respect to drafting. Compare this result with the fact that there were 270 overtime hours worked during June.

The utilization of draftsmen is the responsibility of the head of the drafting department. This is in contrast to control of draftsmen charges to a specific project—the responsibility of the project manager. Because chargeable time of draftsmen has not met the standard, the department head should have some explanation and plans to improve manpower utilization. The report in Exhibit 2 shows current month figures, but a similar report would also be prepared on a year-to-date basis.

**Worth of talent**

The earning assets of a professional firm are its professional or technical personnel. By billing the services of these people the firm creates revenue; revenue in turn must cover not only the salary costs of the professional people but also those of the firm's administra-



ARCO CONSULTING ENGINEERING COMPANY  
EVALUATION OF PER DIEM RATE STRUCTURE

Step		Partners	Associates	Total Firm
Per Person:				
1	Total hours	2,080	2,080	
	Vacation/holiday hours	240	160	
	Available hours	1,840	1,920	
	Budgeted chargeable ratio	60%	80%	
	Chargeable hours	1,104	1,536	
2	Per hour rate	\$ 40	\$ 20	
	Per diem rate - 8-hour day	\$ 320	\$ 160	
	Billable value (rounded)	\$ 44,000	\$ 31,000	
	Number of personnel	3	6	
	Total billable value	\$132,000	\$186,000	\$318,000
3	Budgeted expenses			
	Drawings	\$ 45,000		\$ 45,000
	Salaries		\$ 66,000	66,000
	Other expenses			147,000
	Total			\$258,000
4	Planned Profit Contribution			\$ 60,000
	Per Partner:			
	Planned profit contribution			\$ 20,000
	Partner drawings			15,000
	Total planned distributable income			\$ 35,000

EXHIBIT 3

As all overhead expenses. The remainder is the firm's profit.

A common way of ensuring that adequate provision for overhead and profit will be made is to establish a per diem or per hour fee structure or a standard billing rate for each professional man. This is often a standard multiple or markup of salary cost, although deviations from the standard may be made in recognition of special talents, advanced standing, or occasionally for different types of consultation or work. The markup contemplates that not all of the professional man's time will be chargeable to client work. Hence the chargeable ratio we have discussed is an important input to establishing a per hour standard. The markup also appears to contemplate that the billing for any particular client engagement will be based on professional time expended on the work. We know, of course, that this is not universal practice; to take legal work as just one example, a number of factors other than time spent can enter into fee determination—the result obtained for the client, ability to pay, possibility of continuing work, nature of services, and so on. For example, an attorney may prepare a client's will for a nominal fee, unrelated to the time actually spent in preparation, in anticipation of subsequent work.

The establishment of a per hour billing rate can be accomplished in one of two basic ways:

*Use of a going rate*—Under this method the firm can determine by inquiry how other firms value an hour's worth of chargeable time by partner or employee classification. A set of rates based on the findings can then be established.

*Use of a pay rate multiple*—A second approach is to develop a billing rate based on a multiple of the payroll rate of an employee or the equivalent drawing rate of a partner. For example, in many architect offices a factor of two and one-half times payroll cost has been used historically to compute fees specifically based on time.

Exhibit 3 on this page shows the evaluation of a per diem rate structure based on a planned chargeable ratio and expected earnings level using the going rates for this type of firm. Regardless of how the per diem rate is established it must provide for the planned profits and expenses of the firm.

The requirements for evaluating a per diem rate structure on this basis involve several steps and assume the use of a budget or profit plan.

*Step 1:* The total expected chargeable hours are calculated based on budgeted chargeable ratios. In the exhibit, the total hours figure is based on a 40-hour week for 52 weeks. Firm policy provides for vacations of four weeks

for partners and two weeks for associates and for ten holidays. The chargeable ratios are based on prior experience and on what is considered desirable performance, recognizing the need for promotion and other activities.

*Step 2:* The per hour rate is multiplied by the chargeable hours calculated in Step 1 to determine the total billable value per person. This value is then multiplied by the number of persons in each category to determine the total billable value for the firm.

*Step 3:* The total budgeted charges for partners' drawings, associates' salaries, and other expenses are summarized to determine the total costs for the firm.

*Step 4:* The total planned profit

contribution is determined by subtracting the budgeted costs from the total billable value. That total is then divided by the number of partners to determine the planned profit contribution per partner. If the results do not meet the partners' objectives, a new rate structure can be determined and evaluated in a similar manner.

The per diem concept has three distinct advantages for the professional firm:

1. It provides a ready means of arriving at a fee based on time spent or of assessing the gain or loss in standard profit where the fee is determined on a basis other than time.

2. It provides a bench mark for evaluating the profitability of limited fee arrangements by comparing the limited fee with the per diem equivalent of the time actually spent or expected to be spent on a budgeted or before-the-fact basis.

Although most professional men are familiar with the per diem concept, they often fail to realize its full benefits. Doctors and dentists usually think of each visit or operation in terms of its retail (per diem) value. But many other professional people, especially those involved in long-term projects, measure their ultimate profitability only in terms of billings in excess of direct payroll costs, neglecting to compare billings and the per diem value of the work. This practice is unsatisfactory because of the natural tendency to regard as profitable any engagement that covers its direct payroll costs. The measure of profitability should include an evaluation of the amount of overhead recovery and profit provided by the engagement measured against the standard, or per diem, value. Variations or sacrifices from the per diem value of work contain two elements that may be overlooked: excess payroll costs that must be paid out of the gross profit on the engagement—thus reducing the overall gross profit below the standard—and lost opportunities to put those excess payroll costs to work earning their normal per diem values elsewhere.

Any writeups or write-downs of per diem value should be reported to the firm's management and to the engagement partner responsible for the variation.

Some firms compute actual overhead rates and apply overhead costs to personnel costs that are charged to engagements on a retroactive basis. This practice really serves no purpose. It does not help to control overhead because these expenditures can be controlled only at the source and at the time made. Moreover, individual engagements are not responsible for the level of activity in the firm or for the amount of overhead expenditures—the factors determining the overhead rate—and their profitability should not be viewed in light of these factors.

The per diem rate affords a better measure of profitability than the use of the overhead rate described, and its administration is easier. This is not to say that the comparison of overhead expenditures to chargeable payroll is not important; on the contrary, it should be made regularly. Significant variations from the planned overhead rates—provided they are justified and approved by management—should then be reflected in the per diem rate along with any changes in the desired profit factor.

From the standpoint of overhead cost, a critical factor affecting a professional firm's profitability is its ability to maintain a realistic balance between professional and support personnel. This balance is one of the basic factors determining the ratio of productive costs to overhead costs inasmuch as the costs of support personnel account for a major portion of all overhead costs.

The sheer number of personnel cannot tell the whole story; there are many options of substituting equipment costs or costs of outside services for personnel costs. In addition, there can never be a direct correlation between the number of professional and support personnel.

Consequently, the soundest method for controlling overhead cost is

to incorporate a well constructed budget of overhead expenses into a per diem structure. The achievement of firm profits can then be reviewed by cause and effect, including maintenance of chargeable ratio, billing per diem value, and control of overhead spending within budget.

The establishment of the worth of time and talent provides a valuable key control factor, not only to assure adequacy of fee negotiations and billings but also to provide a standard for revenue control and to assist in the analysis of profit leaks.

As a simple overall example: The Arco Consulting Engineering Company, with three partners and six staff personnel, shows a profit for the fiscal year of \$42,000, assumed to be shared equally by the three partners:

Billings (memo)	<u>\$218,000</u>
Cash receipts	<u>220,000</u>
Expenses—	
Salaries: Professional	100,000
Office	30,000
Payroll costs	6,500
Rent	18,500
Utilities	10,000
Other	<u>13,000</u>
Total expense	<u>178,000</u>
Partner profit	<u>42,000</u>
Per partner	<u>\$ 14,000</u>

The adequacy of this income for the partners is, of course, up to them; let us suppose that each partner agrees it is not adequate and that each should earn \$36,000. The basis on which the achievement of this goal was planned is shown in Exhibit 4 on page 29; the notes tell why the result was not achieved—little profit leaks that totaled almost two-thirds of the expected income.

**Ability to bill for services**

In addition to controlling the chargeable hours worked by its personnel, the firm must control the execution of its billing policy. The maintenance of a desirable chargeable ratio and an adequate per diem structure for its personnel does not of itself assure the firm its desired profit. The firm also must be able to bill the time charged at some

acceptable rate in order to earn this profit.

Two points are important in this connection. The first is the necessity of arriving at a clear understanding with the client on the amount to be billed or on the means of calculating the amount and the timing of billings. This understanding should be reached as early in the engagement as possible. The second point, already mentioned, is that the profitability of any engagement should be measured against a standard and that any variations from the standard should be recognized as such. The standard used for this purpose should be the per diem value of the work, because this figure already contains the elements of budgeted chargeable ratios and overhead and of planned profit.

Any engagement whose billing does not equal the per diem value of the work involves the firm in a

**Jones and Trentin: Better Management Control in the Professional Office**

written down or writeup. Both types of adjustments should be approved at a high level in the firm and should be clearly identified in financial reports. The advantage of this approach is the opportunity it affords for identifying all variations from the desired markup with the particular client or engagement involved, the responsible principal or manager, and the type of service or work performed.

There may be several reasons why a certain engagement is billed at other than the per diem value, but these are reducible to two from an internal management point of view:

1. The client and firm management negotiate a fee based upon billing rates different from the per diem structure.
2. The time expended to complete the engagement is different from the time billable for the work.

Because the reasons for the write-down or writeup are somewhat different under each condition, a distinction should be made in the management reporting of each. The distinction basically reflects whether the fee adjustment results from fee negotiation or from engagement performance. This distinction is important in most firms, inasmuch as the responsibilities for engagement performance and for fee negotiation do not always rest with the same individuals.

The ability to make this distinction of responsibilities depends upon the development of a budget for the engagement in terms of man-days multiplied by the appropriate per diem rates. When approved, this budget becomes, in effect, the engagement manager's contract with the firm management, and any difference between this budget and the actual fee negotiated becomes

**EXHIBIT 4**

**ARCO CONSULTING ENGINEERING COMPANY  
SIMPLE PROFIT AND LOSS STATEMENT  
Year Ended March 31, 19\_\_**

<i>Profit Gain Or (Loss) From Standard</i>	<i>Notes</i>	<i>Description</i>	<i>Actual</i>	<i>Standard</i>	<i>Standard Based on —</i>
<u>(\$ 30,000)</u>	1	Chargeable fees	\$258,000	\$288,000	80% chargeable ratio and \$20 per hour
		Fee reductions			
		Fixed fee negotiated	( 15,000)		
		Project inefficiency	( 10,000)		
<u>(\$ 7,000)</u>	2	<i>Total</i>	<u>(\$ 25,000)</u>	<u>(\$ 18,000)</u>	5% of fees budgeted
( 15,000)	3	(Increase) decrease in unbilled work	(\$ 15,000)		
<u>(\$ 52,000)</u>		Fees billed	\$218,000	\$270,000	
2,000	4	(Increase) decrease in accounts receivable	2,000		
<u>(\$ 50,000)</u>		Cash receipts	\$220,000	\$270,000	
( 16,000)	5	Expenses	178,000	162,000	162% of professional salaries
<u>(\$ 66,000)</u>		Partner profit	\$ 42,000	\$108,000	
<u>(\$ 22,000)</u>		Per partner	\$ 14,000	\$ 36,000	

	<i>Profit (Loss) Per Partner</i>
<sup>1</sup> Failed to get expected utilization on billable work. ....	(\$10,000)
<sup>2</sup> Poor project management. ....	( 2,333)
<sup>3</sup> Inadequate attention to billing. ....	( 5,000)
<sup>4</sup> Accelerated account collections. ....	667
<sup>5</sup> Failed to hold overhead spending to budgeted overhead rate of 162% of professional salaries. (Actual overhead was 178% of professional salaries of \$100,000.) .....	( 5,334)
	<u>(\$22,000)</u>



LIMA, ALPHA & HAMILTON  
 FEE ADJUSTMENTS REPORT  
 Year to Date Through Tenth Period

Attorney	Total as % of Fees Billed	Better (Worse) than Per Diems						
		Total	Wills, Estates, And Trusts	Litigation and Administrative Agency	Corporate	Domestic Relations	Taxes	Real Estate
H.V.J.	( 6)	(\$ 8,200)	\$ 3,000				(\$11,200)	
C.E.R.	(30)	( 33,420)	( 3,000)	(\$30,420)				
R.E.G.	45	62,000	(1) 80,000		(\$15,200)		( 2,800)	
C.C.A.	(10)	( 29,000)			( 2,000)	(\$8,000)	( 19,000)	
M.B.A.	(40)	( 40,000)						(2)(\$40,000)
J.S.K.	4	20,000	20,000					
R.L.	( 1)	( 1,000)			( 1,000)			
<b>Total</b>	<b>( 3)</b>	<b>(\$29,620)</b>	<b>\$100,000</b>	<b>(\$30,420)</b>	<b>(\$18,200)</b>	<b>(\$8,000)</b>	<b>(\$33,000)</b>	<b>(\$40,000)</b>
Percent of total fees billed		( 3%)	20%	( 60%)	( 6%)	( 10%)	( 50%)	( 40%)
Significant Clients								
Harris Estate			(1) \$ 50,000					
Able -Baker Realty Co.								(2) (\$30,000)

EXHIBIT 5

management's fee bonus or fee sacrifice. The actual billings should identify the amount of this variance as well as of any variations from the approved budget. Variations from the approved budget would be the responsibility of the man assigned to supervise or carry out the work.

In the final analysis, the ability to bill for services is controlled by monitoring fee adjustments from the planned per diem structure (writeups and writedowns). Although resolution of any individual client billing may appropriately result in a fee adjustment, the net of all writeups and writedowns for the firm as a whole must be balanced off to achieve a consistent and acceptable level of profit. The net effect of such fee adjustments for the mythical law firm of Lima,

Alpha & Hamilton is shown in Exhibit 5 on this page.

**Unbilled and billed charges**

Another important control factor for the professional firm is the management of its unbilled and billed charges. The objective of such a control is to insure that all charges are billed and that all billings are collected. In addition, it is important for the firm to know and to control both the level of its unbilled work and the amount of cash on hand for immediate requirements.

The controls over unbilled and billed charges can be built on a few basic accounting techniques. Management's exercise of these controls is then reflected in various management reports. These reports indi-

cate the planned level of billed and unbilled charges, cash on hand, and cash receipts and disbursements and show actual results against the plan, highlighting any significant deviations.

Ratio techniques can be employed to compare the current investment in billed and unbilled client charges to a planned level. The planned level may be established by management in terms of an acceptable level of weeks or months of charges that the firm is willing to carry as an investment in its work-in-process inventories. For example, if the firm establishes a policy that all clients should be billed every eight weeks on an average, its current client inventory level should not exceed the last eight weeks of fees charged to in-

ventory. The weekly average of this total may be calculated and divided into the current inventory balance accumulated at per diem rates. The number of weeks calculated in this way can then be compared with the pre-established performance standard. The ratios in this type of comparison will emphasize the importance to the firm as a whole of predetermined levels of cash, unbilled inventory, and accounts receivable. In addition, the use of the number-of-weeks targets enables each engagement manager to bill and to collect individual jobs within those targets, thus keeping the firm as a whole within the prescribed levels.

The example of one law firm illustrates this technique. By converting current charges to inventory to a weekly equivalent and dividing it into the overall unbilled charges, the firm found that its level of such charges represented almost 48 weeks of fees. The partners agreed that 13 weeks was a reasonable target, and a concerted effort to bill out charges was undertaken. Every engagement unbilled within the prior 13 weeks was scrutinized, and billing activity stepped up noticeably. As expected, a significant increase in cash flow resulted, and the investment in unbilled charges was reduced.

Exhibit 6 on this page shows a monthly report of balances used by an engineering firm to exercise these controls.

### Acceptance of work

Fundamental to any discussion of control of time or billings is the question of client arrangements. One of the best services a professional firm can render to itself and its clients is the early development of a clear agreement as to the services to be performed and the basis for billings. In many cases this agreement may take the form of a written contract; in others it may be only a letter of understanding. Regardless of the degree of formality, the terms of the understanding should be specific.

### Jones and Trentin: Better Management Control in the Professional Office

In addition, all client arrangements should be documented within the firm in a standardized format. Regardless of whether it is called an engagement notice, new case memorandum, or by another title, the form will serve to activate accounting and business controls and pinpoint engagement management responsibility. It is essential to specify the technical requirements and objectives of the engagement as well as the administrative details, including client responsibilities for liaison and project participation.

As important as the preceding details is a specific understanding with regard to the amount and method of computation of the fee and the timing of billing. It may not be possible or even desirable to agree on the amount of the fee at the beginning of the engagement. What should be settled, however, is the basis of calculating the fee and the details of billing arrangements.

Several methods of fee calculations are commonly used today.

However, professional work is done either under open-ended or limited fee arrangements. The open-ended arrangements, which include recovery of useful time charged at normal per diem rates, are normally preferable from the viewpoint of the professional firm. However, the fact is that more and more work each year is being offered on the basis of a limited fee, not only by governmental agencies but by many clients who control this type of cost by a program budget of limited amount. It then becomes necessary for the professional firm to determine if it can expect to earn the desired profit under a particular limited fee proposal and if its expectations are being realized, both during and after the completion of the engagement.

The question of billing arrangements is important because it affects the cash flow of the professional firm. As a general proposition, it is to the firm's advantage to bill services as soon after rendering them as possible since the

### EXHIBIT 6

#### ENGINEERING ASSOCIATES SUMMARY OF INVENTORY AND ACCOUNTS RECEIVABLE

Month: September 19\_\_

	Inventory	Accounts	Year to Date	
		Receivable	Actual	Plan
Beginning balance	\$142,000	\$101,000		
Time charged to clients				
— at per diems	40,100		\$352,520	\$380,000
Bills rendered	( 60,000)	60,000	480,640	500,000
Fee adjustments (net)	( 2,100)		( 28,000)	( 19,000)
Cash receipts		( 63,000)		
Bad debts		—	3,000	—
Ending balance	<u>\$120,000</u>	<u>\$ 98,000</u>		

Number of Weeks of Fees:

	Total	Inventory	Accounts Receivable
Standard	21.0	13.0	8.0
Current month	21.8	12.0	9.8
Last month	24.3	14.2	10.1
Year ago	51.1	35.3	15.8

**One of the best services a professional firm can render . . .**

January 30, 19--

Mr. T. B. Smith  
Partner  
Beta Associates  
95 Lee Street  
Chicago, Illinois 12101

Dear Mr. Smith:

In accordance with our recent conversation we are pleased to submit this proposal for professional services:

Scope

We understand that you now occupy about 50,000 square feet at the above address, that you anticipate substantial expansion in the next few years, and want to plan now for acquiring the additional space which will be needed. You wish professional assistance to help you determine what your space requirements will be; to find the best solution to these requirements, either in 95 Lee Street or elsewhere; and to plan and implement a move into the new space.

We propose to assist you in this project as outlined below in three phases of work:

Phase I--Determination of Requirements

This would be a study of your present requirements and how they will probably change and grow during the period for which we will be planning. It would include a description of the amount, type and distribution of space required as well as other physical and environmental factors.

Phase II--Site Analysis and Lease Negotiation

Having established your requirements in Phase I, we will analyze the plans and lease terms of the two or three most likely sites as recommended by your real estate consultant and compare them with the space available at 95 Lee Street.

Phase III--Planning and Construction

Once the new site has been decided upon, we will do the following work to implement the move:

- A. Planning
    - 1. Block Layouts  
We will revise and refine Phase II for your final approval.
    - 2. Detailed Layouts  
After your approval of the block layouts, we will prepare detailed layouts of each room, showing the position of walls, the position of furniture, etc.
  - B. Design Standards  
We will prepare design and design standards for the space standards established. These standards include:
    - . Design concept
    - . Color palette
    - . Partitions
    - . Flooring
    - . Ceiling
    - . Finishing items--walls, doors, etc.
    - . Accessories
    - . Furniture
  - C. Letting of Contracts  
For any construction and contracting work, we will suggest drawings which is not a part of our contract. We will suggest contractors, send them to the site for an analysis of bids and select the best one.
  - D. Coordination and Construction  
Coordination as required with the contractor. Construction remains on schedule. We will make known and are covered by our supervision of all phases of the work to insure that methods and materials meet the drawings and specifications.
- Fees
- A. Our fees for the above work will be (2 3/4) times the payroll of the staff for your account.
  - B. 1. In the event that you desire a total fee for all three phases, we will charge 10 per cent of the total cost of the space and decorating the space to include the price paid for architectural, electrical, and plumbing work, painting, cabinet work, furniture, etc.

. . . is a clear, written agreement as to services to be performed and fees.

Block layouts prepared in

Block layouts, we will prepare  
document showing all interior  
equipment, and personnel.

ing standards to complete  
Phase I. These areas in-

erings, drapery, carpet, and

work called for on the above  
the landlord's work, we will  
drawings out for bid, and assist  
in the signing of contracts.

Inspection  
Contractors to insure that  
and that any changes required  
are noted in writing. Inspection and  
acceptance, including landlord's  
approval, materials conform to the draw-

two and three-quarters  
personnel actually working

When we move to a new location, the  
costs will not exceed an amount equal  
to the cost of constructing, finishing,  
and equipping by you. Such costs to  
include interior construction, mechanical,  
and electrical work in your space and all finish-  
ings, carpets, drapery, and accessories.

Should the landlord undertake, as a part of his lease responsi-  
bility, to assume part of the above costs, we would have no  
way of determining the actual cost of his share of the work.  
In that case we would negotiate a formula for arriving at an  
equivalent to 10 per cent of costs.

2. In the event that you should decide to rent additional  
space at 95 Lee Street and renovate parts of your existing  
space, our total fee would not exceed 12 per cent of the costs  
outlined above.

C. In addition, we are to be reimbursed at cost for any out-of-  
pocket expenses for such items as blueprints, telephone,  
carfare, filing fees, and so on, including any extraordinary  
expenses that we may incur at your request and with your  
approval.

D. The above fees do not include the cost of any engineering or  
other consulting services which may be required. These fees  
would be billed directly to you at cost.

Billing

Invoices will be submitted monthly in accordance with actual pay-  
roll costs against an estimated total fee.

General Terms

A. Notwithstanding the foregoing, you shall have the right to  
terminate the scope of the work outlined above at any time  
upon five (5) days written notice to us. In this case, we  
shall be compensated for work already done at a rate of two  
and three-quarters (2 3/4) times payroll.

B. Any changes made by you after approval of the detailed layout,  
which shall require additional work, shall be paid for by you  
as an extra charge, above estimate, at a rate of two and  
three-quarters (2 3/4) times payroll.

C. The scope of the work may be modified or expanded, in which case  
a new letter of agreement would be executed so that we have a  
mutually clear understanding of our responsibilities.

Your signature of acceptance below will make this proposal the  
agreement between us and authorize us to proceed with this project.

Sincerely,  
ABC Associates, Inc.

Accepted for Beta Associates

By: \_\_\_\_\_

Title: \_\_\_\_\_

Date: \_\_\_\_\_

Martin A. Johnson  
President

firm's biggest cost—its payroll—must be met on a current basis. Some firms, especially in limited fee engagements, are inclined to defer billings on the theory that this “saves some of the gross profit for later” and avoids making a contract look too profitable—until the profitability has been well established by performance.

The question of profit recognition and timing is really separate from the question of cash control, and one should not influence the other. Proper accounting techniques can be employed to reflect profit realistically; it should not be necessary to delay billings merely to accomplish this purpose. Whether interim billings are made on the basis of costs incurred for the period or on some measure of physical completion, the question of profit accounting and cash control can and should be considered separately.

#### **Out-of-pocket expenses**

The classic tradition, still followed in many firms, is that any expenses incurred by the firm or its personnel in behalf of a client should be reimbursed by the client. In some cases, however, certain out-of-pocket expenses are considered firm overhead and are recovered through the per diem rates billed. Where these expenses are not normally billed separately, it seems reasonable to assume that excessive costs incurred for these specific items as a result of specific client requests should be billable to the client. An example of the latter situation might be the cost of preparing more than a normal number of copies of reports, documents, drawings, or other, similar items.

Other types of out-of-pocket expenses associated with the client engagement—such as supper money, overtime premium, and travel and communication expenses—may or may not be reimbursable under any particular arrangement. Because nonreimbursable expenses must be subsidized out of the firm's gross profit, it is advantageous to provide for the reimbursement of expenses

wherever possible. Regardless of what arrangements are finally negotiated with the client, it is important to specify the types and amounts of expenses to be reimbursed. In many cases, expenses which could be reimbursable are not recovered merely because no provision for them was made in the initial agreement.

A corollary but important benefit of having a specific understanding with the client on the terms of an engagement is the opportunity it affords of identifying work which is not a part of the original agreement. It may not be possible to determine in advance if the additional work will be billable, but it is important to collect this time separately to avoid distorting the profit on the initial agreement. In addition, knowing the amount of time accumulated on each extra project can be an important factor in determining whether it is to be billed and at what amount.

An illustrative arrangement letter of an architectural firm might look something like the one shown in Exhibit 7 on the preceding pages, 32 and 33.

#### **Conclusion**

The management of a professional firm can improve its control over the economic results of operations by looking at the key factors of management control. These can be summarized for professional work as follows:

1. The utilization of professional personnel as reflected in chargeable times ratios
2. The worth of talent predetermined in accordance with an acceptable per diem structure, with controlled overhead
3. The ability to bill adequately, based on control of fee adjustments from the per diem structure
4. The investment in time charges, billed and unbilled, kept within pre-established targets based on a planned level of operations
5. The acquisition of work based on acceptable engagement arrangements

***The classic tradition, still followed in many firms, is that any expenses incurred by the firm in behalf of a client should be reimbursed by the client. Where certain out-of-pocket expenses are not billed separately, it seems reasonable to assume that excessive costs incurred for these specific items as a result of specific client requests should be billable to the client.***