Overhead Costs of Ancillary Businesses

Seeking to differentiate their firms in a competitive legal marketplace by providing a broader range of services, an increasing number of law firm planners find themselves performing a cost-benefit analysis of proposed ancillary businesses -- non-legal ventures that offer services complementary to those provided by the law firm. Services provided by ancillary businesses include, among others: advertising, consulting, claims administration, document management, government relations, human resources, real estate appraisals, real estate development, title insurance services and tax counseling.

Analyzing Costs Comprehensively

As part of their due diligence evaluation, firms need to assess carefully both the start-up/acquisition costs of the ancillary business and its ongoing operating costs within the law firm's structure. Unfortunately, many planners end this analysis prematurely, making their "go /no go" decision on the basis of weighing anticipated revenues against only the acquisition and historical operating costs of the ancillary business. To fully assess the profitability of a new venture, planners also need to take into account the overhead costs of operating the business within a law firm. In our experience, most planners underestimate these overhead costs.

Note: For simplicity, this article disregards tax considerations when it assumes that a firm wants its ancillary business to show a net operating profit.

Like law firms, the vast majority of ancillary businesses are service-oriented in nature. But calculating and comparing overhead costs can be tricky, since many ancillary businesses have -- and need -- a very different cost structure from that of the law firm.

Overhead Differences and Profitability

Typically a law firm tries to integrate an ancillary business into the firm's operations to achieve economies of scale, which may be real or imagined. When overhead cost structures of the two organizations differ greatly, however, such consolidation can result in red ink even if the ancillary business would be profitable on a stand-alone basis.

For example, a small independent lobbying practice can have a profit margin of up to 90%. This margin can shrink considerably if the lobbying operation is acquired by a law firm and then a portion of the law firm's overhead costs is allocated to it.

Following are some major components of a law firm's overhead structure that may differ significantly from those of an ancillary business in stand-alone mode:

Office Space -- For many ancillary businesses, an important key to profitability is that they require only low profile, inexpensive office space. To move them into a law firm's relatively sophisticated, expensive office space and then charge them accordingly, even at a fair internal charge rate, may dramatically alter their profitability.

Technology -- In law firms that seek to provide fully integrated and seamless services in a "one-firm" environment, an acquired business is often appended to the firm's technology platform. The firm's standard platform, however, may include overly sophisticated hardware or software that are not needed by the ancillary business. For example, an expertise-based ancillary business may have very little use for the firm's practice-oriented knowledge-management systems. The associated internal charges for these unnecessary services may materially impact the financial position of the ancillary business.

Administrative and Professional Costs - Many law firms have an administrative staff (secretaries, accounting staff, housekeeping, etc.) that is roughly the same size as the attorney staff. Ancillary businesses often require much smaller administrative support structures. Furthermore, the overhead structure of a law firm may include items of no relevance whatsoever to the ancillary business, such as depreciation, interest expenses, off-site storage, legal staff recruiting, legal services marketing and continuing legal education. Allocating unneeded overhead costs to an ancillary business is the equivalent of a business tax by the law firm.

Analyzing overhead costs such as the above will ensure that the law firm is well informed with respect to the real costs (and profits) associated with an ancillary business as the law firm will measure it in the future -- not just at the time of acquisition. Comparing **Business Opportunities** In many cases a firm's planners need to compare multiple investment opportunities. Realistic comparison requires consistency in the supporting analyses.

Therefore, at the onset of the evaluation process, be sure to set fair charge-back rates and overhead allocation policies for all ancillary businesses. Then use this information to develop pro forma financials for a three- to five-year planning horizon for each opportunity. It is only through reliable information, sound analyses, and strategic direction that the right decision can be reached.