

Developing Budgets and Financial Forecasts

Contributed by Michael A. Webber, A/E FINANCE

The AIA collects and disseminates Best Practices as a service to AIA members without endorsement or recommendation. Appropriate use of the information provided is the responsibility of the reader.

SUMMARY

Regardless of the accounting or finance topic of concern to an architecture firm, the analysis and answers will always come down to people, more specifically, the salaries and salary-related expenses for the people working for a firm. Recognizing and understanding this is as essential for developing an overall firm budget as it is for monitoring and managing all operational activities of a firm, regardless of size.

INTRODUCTION

A 'budget' is nothing more than an estimate of revenues and expenditure for a set period of time, with the difference between the revenues and the expenditures being a profit, if revenues are higher, or a loss, if expenditures are higher. It is a systematic plan for the realization and expenditure of usually fixed resources, such as money and time, during a given period. In architecture, it is the abilities and hours of its staff that a firm 'sells,' and realizing enough fee to cover the costs of all its staff and other overhead expenses, in expectation of having additional monies, or profit, left over at the end of that period.

However, budgets generally are not considered a sterile set of numbers put together by someone working in a vacuum. Budgeting is an integral part of every planning process, along with strategic, operations and marketing planning. In fact, budgets are simultaneously a numeric interpretation of these other activities. They are a dynamic guideline for determining in advance whether these other plans make sense, can be accomplished, and are be undertaken, as well as whether the firm has the resources to successfully achieve the plans' simultaneous goals.

It is a common misnomer that a 'budget' only means a limit or constraint. Depending on the situation, it is good to exceed budget, such as with revenues, come in well under budget, such as with interest expenses, or fully (or at least optimally) spend budgets such as with training and continuing education and marketing.

Before going any further, it is appropriate to establish the broader context within which 'budgets' will be discussed: *It is the responsibility of every manager at every level of an architecture firm to efficiently and effectively utilize staff and other resources to execute projects at a quality level at*

least up to the standards expected by the firm and the client, while at least achieving some profit. Whether to target for some profit or a stretch profit is within the prerogative of the firm's owners.

The basics of accounting and budgeting, for architecture firms are not complex. However, an understanding of certain fundamentals – by every manager at every level of a firm – is imperative for the firm to be able to plan and manage towards its goals and profit. Firms need to make profit; those that do not, literally, will not be able to keep their doors open.

PROFIT & LOSS (P&L) STATEMENT AND BENCHMARKS FOR BUDGETING

The Income Statement (Profit & Loss Statement) has only one category in which to record revenue and five categories in which to record expenses. Of the expense categories, there is a differentiation between direct (project-related) costs and indirect (non-project-related) costs, and within each of these, a differentiation between labor and non-labor-related expenses. As a result, the broad categories on an Income Statement are Direct Expenses, Direct Labor, Indirect Labor and Indirect Expenses. (Note that Indirect Expenses actually has two components, one of which is quasi-labor related expenses, and one that is not.) Subtract these expenses from revenues, and the amount remaining is called Operating Profit/Loss – the pre-bonus, pre-tax profit or loss a firm derived from its operations.

The amounts used in this exhibit do, albeit loosely, reflect the historic proportionate averages of the architecture industry for each of the basic categories shown, and will be used to show how the basics of an architecture firm's annual budget can and should be developed. *Note: All amounts & statistics shown are consistent with long-term historic results as verified in publications and reports developed by long-established companies such as PSMJ and ZweigWhite.*

HISTORIC BENCHMARKS FOR BUDGETING

As the historical average operating profit rate for the industry has been $\pm 10\%$ of net revenue, the historical average operating expenses have been $\pm 90\%$. Certainly many firms make more than 10%, but that unfortunately also means many firms make less, too often including operating losses, too. More often than not, the difference between profits and losses are reflected in the proportions

Table 1		
Basic Income Statement		Operating Expenses
Total Revenue	\$ 131,600	
Direct Expenses	31,600	---
Net Revenue	100,000	
Direct Labor	33,333	37.0%
Gross profit	66,667	
Indirect Labor	21,333	23.7%
Payroll-Related Expenses	10,113	11.2%
Other Indirect Expenses	25,220	28.0%
Operating Profit/ <Loss>	\$ 10,000	
(Pre-Bonus, Pre-Tax)		
Key Performance Indicators		
Total Labor	\$ 54,666	60.7%
Tot Lab + P/R-Related Exp	\$ 64,780	72.0%
Other Overhead	\$ 25,220	28.0%
Operating Profit Rate	10.0%	
Net Multiplier	3.00	
Utilization Rate	61.0%	
Payroll Multiplier	1.83	
OH Rate w/o Bonuses	170.0%	

Indicators that directly reflect payrolls and the utilization of staff in the production of projects.

BASIC METRICS: UTILIZATION RATE, NET & PAYROLL MULTIPLIERS, AND OVERHEAD RATE

Within the architecture industry, four of the most widely known and monitored financial metrics are the firm's "utilization rate," its "net multiplier," its overall "payroll multiplier" and its "overhead rate." They each relate to the firm's payroll. These same metrics are basic to developing any type of financial and operating budgets' allocation and targets for the firm's greatest expense: labor.

"Utilization rate" answers the question, for all payroll dollars paid, how many go towards working on actual client projects? It is calculated simply as:

$$\text{Direct Labor} / \text{Total Labor}$$

Direct Labor: A firm's own people provide the services that generate net revenue, so Direct Labor costs are the actual wages paid to people for all hours spent working on a client project, and each direct labor hour is recorded to a specific project at each individual person's standard pay rate.

For example, if a person is paid \$1,000 for a standard 40-hour workweek, that person's standard cost rate is \$25.00 per hour. If that person works 5½ hours on a specific project, that project incurs a direct labor charge of \$137.50. Regardless of whether or when these hours actually are billed to a client, the project and the firm have incurred these Direct Labor costs.

Indirect Labor: Total Labor is Direct Labor plus Indirect Labor. Indirect (non-project related) Labor, quite simply, is any time for anyone that is not counted as project work. *Within A/E firms, there tends to be a focus on maximizing project (direct) time. This approach can be counter-productive for the firm.* There are significant amounts of time that go towards necessary and appropriate non-project-related (indirect) activities, some of which may not be obvious. First, there is vacation, holiday, sick, etc., time that all staff receive as an employee benefit. There also is considerable payroll for support staff, people not hired to work on projects, but rather to handle accounting, administrative, HR, and marketing functions.

In addition, there also are significant amounts of time that professional staff spend on *necessary and appropriate*, but

of the various operating expense categories of the individual firm.

The most noticeable and important costs to recognize are salaries. As shown above, actual labor payroll costs are ±60% of total operating expenses – and this should not be a surprise as it is the talents and hours of people that firms have to offer to clients. However, that 60% is not near the total cost of a firm's people. In addition to actual payroll dollars, firms also have to pay payroll taxes, federal and state unemployment and workers' compensation insurance premiums. Next, most all firms provide some level of health and life insurance coverage, perhaps even dental and vision coverage. More often than not, there also are pension or 401(k) programs in place. All these other "payroll-related expenses" add another 16% to 20% to actual payroll dollar costs – and that does not even include the costs of vacation, holiday, sick and personal time, which already are included in the payroll dollars.

Combined, payrolls and other payroll-related expenses average 70% to 75% or more of total operating expenses, and they need to be paid every month – month after month after month. As such, they are, by far, the largest of any firms operating expenses, and are the starting point of any type of budget development or financial forecasting. However, this is facilitated by certain Key Performance

non-project-related activities. Consider the great amounts of professional time dedicated to marketing and business development. Professional staff also need to attend conferences, seminars, webinars, training courses for individual or firm-wide continuing education needs. Last, but not least, there is the undesirable “I-do-not-have-a-project-to-work-on” time that all staff and firms seek to avoid. Finally, there also is the time spent by management staff on administrative and organizational tasks and responsibilities related to managing a firm. As such, *Utilization Rates are to be optimized rather than maximized.*

Utilization Rates can be calculated for each individual department, division, office – wherever someone is responsible for a group of people – as well as for the firm as a whole. A general industry benchmark for utilization rate is 60% to 65% of Total Labor dollars.

Utilization Rates can be monitored daily or weekly, but the Net Multiplier, and, therefore the Payroll Multiplier is monitored only once each month or billing cycle. However, a Net Multiplier can be calculated for each project, if not each phase of a project, and most accounting systems can provide this multiplier on a monthly, year-to-date, and project-to-date basis, or most any other specific date range.

“**Net Multiplier**” answers the question, for every dollar paid for work on actual client projects, how many net revenue dollars does the firm receive in return? It is calculated simply as:

$$\text{Net Revenue} / \text{Direct Labor}$$

The net multiplier can be calculated and monitored for each individual phase of each project every billing period. A net multiplier also can be calculated and monitored for each project manager, department, and division operational unit as well as the firm as a whole by adding together (also called “rolling up”) the net revenues and direct labor every billing period for all projects under the purview of each PM and operational unit. The industry benchmark for net multiplier has remained around 3.0 for decades, with many firms achieving much higher multiples on a project-by-project basis – and many achieving far less.

“**Payroll Multiplier**” answers the question: for all payroll dollar paid, how many net revenue dollars does the firm receive in return? It is calculated simply as:

$$\text{Net Revenue} / \text{Total Labor}; \text{ or}$$

$$\text{Utilization Rate} \times \text{Net Multiplier}$$

The result of multiplying the utilization rate by the net multiplier, this combination makes for the most significant overall of these operational metrics. However, evaluating any change of it requires analyzing each of its two components to determine the cause of any change – positive, negative, or off-setting. Also, as with the net

multiplier, effective multipliers can be calculated and monitored every billing period for each operational unit. Using the industry benchmarks for Utilization Rate (60% - 65%) and Net Multiplier (3.0), the industry benchmark for Payroll Multiplier is 1.80 to 1.95. Also, according to PSMJ research, *the Payroll Multiplier has the highest overall correlation with firm profits because it encompasses both Utilization Rate and Net Multiplier.*

“**Overhead Rate**” (OH) answers the question: for every dollar paid for work on actual client projects, how many dollars of overhead indirect expenses has the firm also incurred? It is calculated simply as:

$$\text{Total Indirect Expenses} / \text{Direct Labor}$$

Overhead includes: Indirect Labor; Other Payroll-Related Expenses, such as payroll taxes, company-paid health insurance, and other benefits; and Other Indirect Expenses, including facility, marketing, corporate, and other staff-related expenses. It will also include Bonuses if a profit is made and shared by the shareholders. All of these costs, calculated as a percentage of Direct Labor, also need to be covered by fees in addition to the labor itself put into a project. OH Rates tend to range around 160% to 170% before bonuses are included. This implies that, for each \$1.00 of Direct Labor and another \$1.60 to \$1.70 for OH, the “Breakeven Rate” for billing labor is \$2.60 to \$2.70. This is consistent with the industry’s Net Multiplier of 3.0 and Operating Profit Rate target of 10%.

THE PAST IS THE FIRST KEY TO THE FUTURE

Setting utilization rate, net multiplier and effective multiplier targets are important tasks in developing a budget and any type of financial forecast, and targets can be facilitated by first looking at historic results. Table 2 provides an example of how all this ties together in order to create a budget.

Table 2 provides the historic results of a hypothetical firm from 2008 to 2011. The year-to-year financial fluctuations are not dissimilar to that of the AE industry’s actual trends during those years, nor are the performance indicators. Operating Profit Rates ran the gamut from a positive 15% followed a negative 15%. The Net Multiplier almost achieved a respectable 3.4 in 2009 before crashing the following year to only 2.25. This could possibly indicate pre-work, working without a contract, or working on a project(s) that never came through and/or was delayed, which would also explain the high Utilization Rate and increase in Total Labor in 2010. Possibly a new or anticipated significant and/or delayed project(s) was finally realized in 2011 returning the firm to profitability. Nonetheless, the firm’s 2010 Pre-tax Loss made the period 2008 – 2011 profitable by an average of only \$31, despite almost a doubling of Total Revenues in 2011.

Now the task becomes understanding what metrics are used to develop the next year's (2012) budget.

Net Revenue Capacity of Staff

Setting minimal targets and monitoring each of these metrics are essential to be able to develop budgets, forecast financial results, and lead the company towards profitability. Presume that the firm intends to start 2012 with staff levels that will result in Total Labor costs similar to 2011, and that, because of 'right sizing' (having the right number of people with the right skills working on the right projects), the firm's Utilization Rate can remain at the industry average 61%. Further, presume that the firm is committed to generating an overall industry average 3.0 Net Multiplier on its mix of projects.

The Total Labor estimate of \$54,666 times the Utilization Rate target of 61% means that there will be \$33,333 of Direct Labor.

The Direct Labor, \$33,333, times the industry average Net Multiplier target of 3.0 means that the firm can achieve \$100,000 of Net Revenue (also known as realizable net revenue), just as in the scalable Table 1 industry average instance.

The calculation is estimated Total Labor cost times the target Utilization Rate times the target Net Multiplier provides the estimate of (or capacity for producing) Net Revenue over any given period. The 2012 budget shown in Table 2, is based on the firm achieving general industry averages of a $\pm 61\%$ Utilization Rate, followed by a ± 3.00 Net Multiplier, or, overall, a ± 1.83 Payroll Multiplier (Net Revenue, \$100,000 divided by Total Labor, \$54,666 = 1.83).

The question then is, how much work does the firm have in backlog (billable fees remaining in current contracts) and can reasonably anticipate in new work over that period?

BACKLOG & FORECASTS OF PROJECTS: BALANCING TO NET REVENUE CAPACITY

Firms are simultaneously working on any number of projects, some of which are years old, and each is in a different phase or stage of completion. A projection for meeting deadlines for each active project also provides a projection of staff needs and anticipated Net Revenue billings remaining from each project. In addition, there also are on-going marketing efforts, and anticipated new work (or lack thereof) which similarly needs to be evaluated and estimated. When summed, the firm has an estimate of the total Net Revenues for the given period.

Table 2						
Basic Income Statement	2008	2009	2010	2011	Avg	2012
Total Revenue	\$ 62,425	\$ 70,230	\$ 63,389	\$ 120,419	\$ 79,116	\$ 131,600
Direct Expenses	10,763	15,051	14,466	30,032	17,578	31,600
Net Revenue	57,018	56,703	52,536	91,595	64,463	100,000
Direct Labor	17,323	16,810	23,335	33,350	22,705	33,333
Gross profit	39,460	39,960	29,812	58,251	41,871	66,667
Indirect Labor	15,515	15,903	17,168	21,321	17,477	21,333
Payroll-Related Expenses	4,809	4,370	6,950	9,503	6,408	10,113
Other Indirect Expenses	13,455	11,393	13,634	18,668	14,288	25,220
Operating Profit (Pre-Bonus, Pre-Tax)	\$ 5,681	\$ 8,295	\$ (7,941)	\$ 8,758	\$ 3,698	\$ 10,000
Bonuses	3,233	3,590	2,445	5,001	3,567	6,000
After-Bonus, Pre-Tax Profit	2,448	4,705	(10,386)	3,757	131	4,000
Other (Income) / Expense	100	100	100	100	100	100
Pre-Tax Profit (Loss)	\$ 2,348	\$ 4,605	\$ (10,486)	\$ 3,657	\$ 31	\$ 3,900
Key Performance Indicators						
Total Labor	\$ 32,838	\$ 32,713	\$ 40,503	\$ 54,671	\$ 40,181	\$ 54,666
Tot Lab + P/R-Related Exp	\$ 37,647	\$ 37,083	\$ 47,453	\$ 64,174	\$ 46,589	\$ 64,780
Other Overhead	\$ 13,455	\$ 11,393	\$ 13,634	\$ 18,668	\$ 14,288	\$ 25,220
Operating Profit Rate	10.0%	14.6%	(15.1%)	9.6%	5.7%	10.0%
Net Multiplier	3.29	3.37	2.25	2.75	2.84	3.00
Utilization Rate	52.8%	51.4%	57.6%	61.0%	56.5%	61.0%
Payroll Multiplier	1.74	1.73	1.30	1.68	1.60	1.83
OH Rate w/o Bonuses	195.0%	188.4%	161.8%	148.4%	168.1%	170.0%

This number is compared with the Net Revenue ‘capacity’ levels, \$100,000 in the example given in Table 2, to see if there is a deficit or excess of work, both short-term and long-term. If, say, the Net Revenue forecast is \$150,000, production staff will need to be increased quickly and/or project deadlines adjusted. If the forecast is only \$50,000, the firm needs to consider the likelihood of obtaining additional work and make serious decisions about whether to keep staff, or consider layoffs. Either way, these decisions need to be made quickly in order to avoid significant fluctuations in operating metrics – and, therefore, profitability – such as those seen in previous years’ financials shown in Table 2.

In most cases, capacity analysis and forecasting are done with consideration of actual utilization rates and skill of staff. This will help determine whether and where there are excesses and/or deficits considering the current projects, phases, and anticipated work.

INTRA-FIRM ANALYSIS

Just as Table 2 showed the year-to-year variances in overall firm metrics and profitability, if the firm is large enough, the same type of analysis can be done for individual divisions, departments, studios, and offices. An example of such an analysis, again using, or resulting in, the same industry average P&L (Table 1) or 2012 budget (Table 2) is used in Table 3 as the Sum of the divisions.

Note that an Administrative unit is included. Firms have staff for accounting, HR, possibly IT and marketing, which are all OH expenses. Further, many OH expenses such as facilities costs, computer hardware and software, various insurance policies, office supplies, and such, are not usually viewed or recorded as expenses of the operating units. Rather, a studio’s projects must generate enough revenues to cover not just its own project labor and expenses, but

Table 3						
Basic Income Statement	Div. 1	Div. 2	Div. 3	Div. 4	Admin	Sum
Total Revenue	\$ 25,000	\$ 30,000	\$ 35,000	\$ 41,600	\$ -	\$ 131,600
Direct Expenses	7,900	7,900	7,900	7,900	0	31,600
Net Revenue	17,100	22,100	27,100	33,700	0	100,000
Direct Labor	8,333	8,333	8,333	8,333	0	33,333
Gross profit	8,767	13,767	18,767	25,367	0	66,667
Indirect Labor	2,750	2,750	3,333	3,333	9,166	21,333
Payroll-Related Expenses	2,050	2,050	2,158	2,158	1,696	10,113
Other Indirect Expenses	1,500	1,500	1,500	1,500	19,220	25,220
OH Allocation	7,328	7,328	7,713	7,713	(30,082)	0
Operating Profit (Pre-Bonus, Pre-Tax)	\$ (4,862)	\$ 138	\$ 4,062	\$ 10,662	\$ -	\$ 10,000

Key Performance Indicators						
Total Labor	\$ 11,083	\$ 11,083	\$ 11,667	\$ 11,667	\$ 9,166	\$ 54,666
Tot Lab + P/R-Related Exp	\$ 13,134	\$ 13,134	\$ 13,825	\$ 13,825	\$ 10,862	\$ 64,780
Other Overhead	\$ 1,500	\$ 1,500	\$ 1,500	\$ 1,500	\$ 19,220	\$ 25,220
Operating Profit Rate	(28.4%)	0.6%	15.0%	31.6%	n/a	10.0%
Net Multiplier	2.05	2.65	3.25	4.04	n/a	3.00
Utilization Rate	75.2%	75.2%	71.4%	71.4%	0.0%	61.0%
Payroll Multiplier	1.54	1.99	2.32	2.89	n/a	1.83
OH Rate w/o Bonuses	163.5%	163.5%	176.5%	176.5%	n/a	170.0%

also a fair and proportionate share of OH expenses. However, the studio does not try to budget for these expenses, unless there are special cases in which a specific unit is incurring specific OH costs, such as certain equipment, its own office, or its own marketing expenses. While such exceptions will be ignored for now, the budgeting of any such expense(s) is recorded within the unit that is incurring the expenses and will have the responsibility for the expenses.

Nonetheless, to get a full picture of the contributions of each studio, a firm allocates all OH costs back to the studios, proportionate to the Total Labor of each unit, because the units must generate enough Net Revenue to cover each unit's share of OH.

The result is that each studio is an individual profit center with its own OH Rate, its own Operating Profit Rate, and, in essence, its own complete P&L. The firm's P&L is nothing more than the sum, or 'roll-up' of the individual unit's P&Ls. The focus of this example will be people (labor amounts), and the operating metrics of each unit. In this example, the figures could be three-year or four-year averages, or even just this year's actuals. (Both current and historic figures are to be analyzed.)

Also, the example is structured such that each of the studios managing the different client or project types has put the same amount of Direct Labor into projects, albeit with quite different Operating Profit results. All four have Direct Labor of \$8,333 (in order to tie into Tables 1 & 2), and modest minimal Other Indirect Expenses of \$1,500. However, studios 1 & 2 have Indirect Labor of \$2,750, giving them Utilization Rates of 75% and OH Rates of 163.5%. Studios 3 & 4 have Indirect Labor of \$3,333, giving them Utilization Rates of 71% and OH Rates of 176.5%. Any number of reasons could explain the Utilization Rate differences, but the most common may be how much time is being dedicated to marketing, an Indirect Labor charge.

The most obvious differences are the Net Revenue amounts generated by each unit, and the resulting Net Multiplier of each, given that each has the same amount of Direct Labor. At 2.05, studio 1 not only had a <28.4%> Operating Profit Rate by losing <\$4,862>, it also did not come close to its 2.635 Breakeven Rate (1.635 OH Rate +1). Studio 2 just made a profit, (0.6%) as its 2.70 Net Multiplier just exceeded its 2.635 Breakeven Rate, which is the same as studio 1's.

Studios 3 & 4 had lower Utilization Rates at only 71.4%, resulting in a higher Breakeven Rate of 2.765 (1.765 OH Rate +1) because Indirect Labor is the largest single component of OH. Nonetheless, with 3.30 and 3.90 Net

Multipliers, respectively, they achieved 16% and 29% Operating Profit Rates, respectively.

Many firms, only looking at the firm's totals which indicate industry average results, could be quite satisfied, regardless of whether these numbers reflect actuals or a budget. Such a conclusion may overlook the facts that the largely disparate results of the different studios are obfuscating inherent problems and opportunities. If these are actual results, projects or client type in studio 1 appear to have serious problems, while projects or client type in studio 3 & especially studio 4 appear to display strengths on which to further capitalize. However, whether these are budget forecasts or historical results, some serious further analysis, reality checks and reallocations of manpower may occur. Depending on the reasons for these results or forecasts, the firm may, in fact, want to discontinue studio 1's activities, unless studio 1 is some sort of start-up and the loss is considered a short-term investment.

OTHER PAYROLL-RELATED COSTS

So far, all that has been considered are Direct & Indirect Labor costs and related metrics. However, there are other Overhead costs to be considered in a budget. The most obvious of these are Payroll-Related Expenses. Statutory costs include the employer's portion of Social Security & Medicare taxes, and federal & state unemployment insurance. Non-statutory costs include other company-provided fringe benefits, such as all or some portion of medical, life & other insurance premiums, and 401(k) & other retirement contributions that are part of the firm's benefit package. Some employees do not realize that such costs cumulatively may add another 15% to 25% to their actual salary.

However, for forecasting and budgeting purposes, most firms will find these costs historically to be a rather consistent percentage of the firm's total payroll costs. With payroll and unemployment taxes of 9% to 10%, 401(k) matching of 0% to 5%, and health and other insurance costs of \$4K to \$10K per person, these costs can easily range from 16% to 20% or more of total salary costs. But since

firms have rather consistent benefit packages from year-to-year, the amount becomes rather straightforward to estimate from historic percent averages, even if it is a surprisingly large cost when actually recognized.

OTHER OVERHEAD EXPENSES

Remember, payroll and payroll-related expenses already comprise 70% or 75% or more of all operating expenses. The remaining amount is still significant, but, as will be explained, not as significant or as controllable as are salaries and the number of employees. That is because some of the largest individual overhead expenses are 'fixed' annual costs.

As shown in Table 4, there are four general categories 'other' OH expenses to be considered that for the most part cover all other operating expenses. These are:

Other Staff Expenses;

Marketing Expenses;

Facility Expenses; and

CORPORATE EXPENSES.

It is not necessary to budget for every line item in each category. In each, there are several major and minor items that can be fairly easily estimated. Also, various small line items can be aggregated into a budget account called "other" or "miscellaneous" An effort to estimate for each and every line item may be a wasted effort because the day-to-day future can be so dynamic. The effort needs not to be in setting arbitrary amounts for each small (in the aggregate) line item, but to be in estimating what is possible and setting an amount for each category's total, while still achieving the firm's Operating Profit target.

OTHER STAFF EXPENSES

Although other staff expenses are not a particularly significant expense category considering overall operating expenses, it is an important category when a firm is doing strategic planning.

Table 4					
Other Indirect Expenses	2008	2009	2010	2011	Avg
Actual					
Other Staff Expenses	1,031	1,069	1,536	2,628	1,566
Marketing Expenses	1,934	1,705	2,003	2,784	2,107
Facility Expenses	9,061	7,262	8,487	11,101	8,978
Corporate Expenses	1,429	1,357	1,608	2,155	1,637
	\$ 13,455	\$ 11,393	\$ 13,634	\$ 18,668	\$ 14,288
% of Net Revenue					
Other Staff Expenses	1.8%	1.9%	2.9%	2.9%	2.4%
Marketing Expenses	3.4%	3.0%	3.8%	3.0%	3.3%
Facility Expenses	15.9%	12.8%	16.2%	12.1%	14.2%
Corporate Expenses	2.5%	2.4%	3.1%	2.4%	2.6%
	23.6%	20.1%	26.0%	20.4%	22.5%

Other Staff Expenses do not include the statutory Salary-Related Expenses or the other general fringe benefits, such as some amount of health insurance a firm provides all employees. Rather, this category is meant to cover the discretionary, but pertinent, expenses a firm incurs because of, or for, employees. An example of these expenses is a firm's strategic decision to pay for professional memberships of some or all staff.

Similarly, a firm decides on the level of staff involvement in its clients' professional organizations and conferences, which can also be as important as their own professional organizations. A firm also considers and budgets for its staffs' continuing and extended professional education, whether mandatory or as part of management development, and whether the education is in-house or requiring travel and registration fees. Further, a firm may want to decide on and plan for "all-staff" activities and events. While not an exorbitant overall amount, at 2% to 3% of total operating expenses, this investment in staff is critical and motivating and, therefore, considered in an annual plan.

MARKETING EXPENSES

Marketing Expenses are the non-salary expenses related to marketing. Whether it is proposal, travel and meeting costs, or meals and entertainment with clients, marketing is part of business. Other such expenses could include brochures, mail campaigns, a firm's website and social media development and maintenance costs, and conference exhibitor and exhibit costs. Salaries related to staff time for marketing are included in Indirect Salaries.

FACILITY EXPENSES

This category is dominated by the rent, utilities, furniture and furnishings, including computer hardware and software. However, rent, in particular, is an example of a major cost that is not controllable in the short term (month-to-month). Lease amounts, along with the utilities and maintenance costs that go with them, are more-or-less fixed for one or more years; budget estimating is fairly straightforward. Depreciation and amortization expenses are mostly fixed as they are the result of purchases in years past. Some other expenses, such as software licenses and equipment leases, also are fairly fixed and able to be estimated.

For other expenses, it is suggested to collect and compare a few years of expenses against a base such as headcount, total salaries or net revenues. These other expenses, individually or in aggregate, may well show a pattern of consistency of proportion to one of these bases. That basis then facilitates the budget estimates.

CORPORATE EXPENSES

Company expenses are those incurred on behalf of the firm as an entity. The largest expense in this category is professional liability / errors & omissions insurance. There also are expenses for non-project-specific legal and accounting services, and other types of non-project-related consultants. A firm also may use this category for various business licenses and taxes.

CONTINGENCY FUNDS

Once category expense totals are estimated or budgeted, the overall total is compared to Net Revenue, with the

difference being the first estimate of Operating Profits and Operating Profit Rate. If profit estimates are too low to be acceptable – or too high to be realistic – each category and line item is massaged until a reasonable (even if a bit aggressive) bottom line is achieved.

However, it is proper and prudent to factor into each category, or in the company category, a contingency amount for unforeseen events or opportunities that may present themselves. There is an “other” or misc.” line item in each category’s initial budget estimate that can facilitate this. Lack of a sufficient contingency reserve may warrant going all the way back to the start of the budgeting process and making changes to total salaries or utilization rate and net multiplier targets.

WORKING CAPITAL REQUIREMENTS

Part of the budgeting process also is determining Working Capital requirements. Working Capital is technically defined as the difference between Current Assets and Current Liabilities, but essentially is monies needed to pay all operating expenses as they occur and are due, and the time invoices are actually collected. Within the budgeting process, oftentimes, the Working Capital comes in the form of profits from the current or previous years that are not paid out as bonuses or distributed to owners. Or these profits are supplemented by having a line-of-credit arranged with a bank. Particularly if growth is sought or expected, additional Working Capital requirements can be significant.

SUMMARY

Setting Total Salaries, Utilization Rate and Net Multiplier targets dictate a firm’s Net Revenue target. Along with Other Salary-Related Expenses, they also dictate up to 75% or more of a firm’s total Operating Expenses. The remaining Operating Expenses still are a significant amount, but are dominated by certain line items that are relatively fixed, and, therefore, less controllable in the short term. As such, it is most important to constantly focus on the performance of people and projects in order to make an Operating Profit. Profits are necessary for the sustained operation of a firm. Profit is the result of the time and talents of a firm’s people that a firm sells, meaning that architecture truly is a ‘people’ business.

ABOUT OUR CONTRIBUTOR

Mike Webber started A/E Finance (www.aefinance.net) after years as a CFO. He works with A/E Principals and Boards on operations & financial analysis & systems, strategic planning, turnarounds, and interim assignments. He has been Chair of AIA Chicago’s Practice Management Committee, an AIA/ACEC Peer Reviewer, and on ACEC’s Management Practices Committee. He can be reached at mawebber@aefinance.net.

RESOURCES

More Best Practices

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

07.02.01 Accounting Basics: The Income Statement & Key Performance Indicators

07.02.02 Accounting Basics: The Balance Sheet & Key Performance Indicators

05.02.03 Starting a Firm: Basic Financial Principles

For More Information on This Topic

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



See also “Developing Annual Budgets and Profit Planning” beginning on page 428 of the 15th Edition of the *Architect’s Handbook of Professional Practice*. The *Handbook* can be ordered from the AIA Store online at www.aia.org/store, by calling 800-242-3837 (option 4), or by email at bookstore@aia.org.



Feedback

The AIA welcomes member feedback on Best Practice articles. To provide feedback on this article, please contact bestpractices@aia.org.

Key Terms

- Practice
- Financial management
- Accounting
- Breakeven Rate
- Budgets
- Direct Labor & Expenses
- Income Statement
- Indirect Labor & Expenses
- Key Performance Indicators (KPIs)
- Net Multiplier
- Net Revenue
- Overhead Rate
- Payroll Multiplier
- Payroll-Related Expenses
- Utilization Rate

November 2012