AIA Best Practices:
Budgeting basics

Part 1 of Developing company financial budgets

Contributed by Michael A. Webber, A/E/ Finance

Summary

Architecture is an art, but it's also a profession—in other words, the practice of architecture must be profitable to remain in business. For a firm to be consistently profitable, it is necessary to understand budgeting fundamentals across every level of a company. In part one of *Developing company financial budgets*, we cover the income statement and various metrics you can use to benchmark your organization's performance.

Introduction

Architecture is an art, but it's also, and perhaps primarily, a profession—in other words, a business. Architects and other design professionals earn their livings practicing architecture; for that to happen, architectural firms need to remain in business, which means they have to be profitable. Managing a firm's finances well is thus an important skill for architects to acquire, and developing financial budgets is an essential part of that skill. This white paper begins a series of five papers that address budget development for architectural firms. The other four papers cover key performance indicators (KPIs), creating an annual budget for a small vs. a large firm, and budgeting indirect expenses.

A budget is nothing more than an estimate of revenues and expenditures for a set period (usually a year), with the difference between the revenues and the expenditures being profit (if revenues are higher) or loss (if expenditures are higher). A budget is a systematic plan for the realization and expenditure of resources, such as money and time, during a given period, as well as the generation of fees to cover the costs of its staff and other expenses, with the expectation of having additional money, or profit, at the end of that period.

However, budgets are not sterile sets of numbers put together by someone working in a vacuum. Budgeting is an integral part of every planning process, including strategic, operational, and marketing planning. In fact, budgets are numeric interpretations of these other activities. They are dynamic guidelines for determining in advance whether these other plans make sense, can be accomplished, and are to be undertaken, as well as whether the firm has the resources to achieve its goals.

Budgets are commonly misunderstood to mean only limits or constraints. Depending on the situation, it can be good to exceed a budget, such as with revenues; to be under budget, such as with expenses; or to fully spend budgets, such as with training, continuing education, and marketing.

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 its goals and be consistently profitable. It's the responsibility of every manager to efficiently and effectively utilize staff and other resources to execute projects. Firms that aren't profitable will literally not be able to keep their doors open.

Income statement and benchmarks for budgeting

There are two primary tools that help to provide an overall financial picture of the company. The first is the income statement, which is the industry standard for organizing budget information. Figure 1 (below) shows a sample income statement. The statement has only one input category (the top line) that records revenue ("total revenue") and five input categories (with red numbers) that record expenditures. Of the expenditure categories, we differentiate between "direct" (i.e., project-related) and "indirect" (i.e., non-project-related) costs. Within the direct costs, we identify direct expenses (typically consultant fees and non-reimbursable expenses) and direct labor. Within the indirect costs, we identify indirect labor, payroll-related expenses, and other indirect expenses.

Figure 1 shows how direct expenses, direct labor, indirect labor, payroll-related expenses, and other indirect expenses are deducted from total revenue to give us the operating profit, positive or negative, before taxes and bonuses are paid, that a firm derives from its operations. One more important term in Figure 1 is net revenue (also known as net service revenue, or NSR), which remains after direct expenses are subtracted from total revenue.

Figure 1: Sample income statement, also known as a profit and loss (P&L) statement

Total Revenue (TR)	**$131,600**	Also known as Gross Revenue
Direct Expenses (DE)	$31,600	Typically consultant fees and non-reimbursable expenses that are project-related
Net Revenue (NR)	**$100,000**	
Direct Labor (DL)	$33,333	Project-related labor
Gross Profit (GP)	**$66,667**	
Indirect Labor (IL)	$21,333	Non-project-related labor
Payroll-Related Expenses (PRE)	$10,113	Payroll taxes, employee benefits, etc.
Other Indirect Expenses (ODE)	$25,220	Includes interest and depreciation
Operating Profit (OP)	**$10,000**	Before bonuses and taxes

Historic benchmarks for budgeting

Figure 2 (below) charts various metrics for benchmarking a firm's performance. Two important metrics are total overhead (defined as indirect labor + payroll-related expenses + other indirect expenses) and operating expenses (defined as direct labor + total overhead). As the historical average operating profit rate for the profession has been around 10% of net revenue, the corresponding average operating expenses have been around 90%. Of course, many firms make more than 10% profit and many firms make less.

For architecture firms, the most significant costs are salaries. Total labor (direct and indirect) should be around 60% of total operating expenses. However, that 60% is not the total cost of a firm's staff. In addition to actual payroll dollars, firms have to pay payroll taxes, and federal and state unemployment, and workers' compensation insurance premiums. Next, most firms provide some level of health (often including dental and vision) and life insurance coverage. Firms may also contribute to employees' pension or 401(k) programs. All these indirect payroll-related expenses add another 16% to 20% to actual payroll dollar costs. (Vacation, holiday, sick, and personal time are already included in the payroll dollars.) Figure 2 below shows how our sample P&L statement in Figure 1 tracks with these benchmarking metrics.

Payrolls and other payroll-related expenses, combined, average 70% to 75% of total operating expenses, and they need to be paid every payday, without fail. As such, they are by far the largest of a firm's operating expenses, and are the starting point for budget development or financial forecasting. However, this is facilitated by certain key performance indicators that directly reflect payrolls and the utilization of staff in the production of projects. In "Part 2: Budgeting Key Performance Indicators," we'll define more budgeting terms and identify the metrics that make up the key performance indicators.

Figure 2: Benchmarking standards

The numbers below are based on the sample income statement from Figure 1.

Total Labor (TL = DL + IL)	$54,666
Total Labor + PRE	$64,780
Total Overhead (OH = IL + PRE + ODE)	$56,666
Operating Profit Rate (OP/NR)	10.0%
Operating Expenses (DL + OH)	$90,000
Total Labor/Operating Expenses	60.7%
Total Labor + PRE/Operating Expenses	72.0%
PRE/TL	18.5%

The percentages highlighted in Figure 2 approximately reflect the historical averages within the architectural profession for each of the basic categories shown, and will be used in Parts 2 to 5 of this Best Practice series to show how the basics of an architecture firm's annual budget can and should be developed. Note: All statistics shown are consistent with long-term historical results as verified in publications and reports developed by long-established companies such as PSMJ and Zweig Group.

In Part 2: Budgeting key performance indicators, we will discuss some industry-standard metrics for tracking your company's performance that will help you understand your financial health and compare it to industry benchmarks.

Developing company financial budgets: the five-part series

This Best Practice begins a series of five articles that address budget development for architectural firms. The other four articles, also found on the AIA's Best Practices webpage, are:

- Part 1: Budgeting basics
- Part 2: Budgeting key performance indicators
- Part 3: Creating an annual budget for a small firm
- Part 4: Creating an annual budget for a larger firm
- Part 5: Budgeting indirect expenses

About the contributor

Michael A. Webber started A/E Finance after years as a CFO. He works with A/E principals and boards on strategic planning, turnarounds, interim assignments, and operational and financial analysis and systems. He has been chair of AIA Chicago's Practice Management Committee, an AIA/ACEC peer reviewer, and a member of ACEC's Management Practices Committee. He can be reached at mawebber@aefinance.net.

About AIA Best Practices

AIA Best Practices is a collection of relevant, experience-based knowledge and expert advice on firm management, project delivery, contracts and more, aligned with the *Architect's Handbook of Professional Practice, 15th edition*. See the full AIA Best Practices collection at aia.org/aia-best-practices.

This article corresponds to:

Architect's Handbook of Professional Practice, 15th edition Unit 1 – The Profession
Chapter 07 – Financial Management
Section 04 – Developing Annual Budgets and Profit Planning