AIA Best Practices:
Budgeting indirect expenses

Part 5 of Developing company financial budgets

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Summary

An essential part of budgeting is the consideration of operating expenses. Overhead expenses can vary widely and knowing your organization's figures will help you finalize your budget and working capital requirements. The most obvious of these are expenses related to payroll, insurance, taxes, and retirement programs. However, there are four other categories of overhead expenses to consider, including: marketing expenses, facility expenses, corporate expenses, and other staff expenses.

Other payroll-related costs

So far in the previous four white papers, we've been considering only direct and indirect labor costs and related metrics. However, we need to include other overhead costs in our budget. The most obvious of these are payroll-related expenses, which include federal and state unemployment insurance and the employer's portion of Social Security and Medicare taxes, and voluntary company-provided fringe benefits, such as medical, life, and other insurance premiums, and 401(k) and other retirement programs. These costs can cumulatively add another 15% to 25% to employees' paychecks. However, for forecasting and budgeting purposes, most firms find these costs to be historically a rather consistent percentage of the firm's total payroll costs.

Other overhead expenses

Payroll and payroll-related expenses already comprise, typically, 70% to 75% 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's because some of the largest individual overhead expenses are "fixed" annual costs.

We will look at four general categories that for the most part cover the other operating expenses: other staff expenses, marketing expenses, facility expenses, and corporate expenses.

It's not necessary to budget for every line item in each category. In each, there are several major and minor items that can be easily estimated. Also, various small line items can be aggregated into a budget account called "other" or "miscellaneous" costs. Estimating each line item may be a wasted effort if the summary lines are consistent and predictable.

Other staff expenses: Although other staff expenses don't make up a particularly significant portion of the overall operating expenses, they do need to be considered in a firm's strategic plan. These include the discretionary but pertinent expenses a firm incurs because of, or for, employees and are usually needed for the firm to be competitive in the labor market. An example is a firm's strategic decision to pay for employees' professional licenses and memberships.

A firm can also financially support its staff's participation in clients' professional organizations and conferences, which can be important for business development. Another optional budget item covers employees' continuing and extended professional education, including travel costs and registration fees. A firm may also want to budget for "all-staff" activities and events. While not an exorbitant overall amount (usually 2% to 3% of total operating expenses), these investments in staff can be critical and motivating and, therefore, should be considered in the annual plan.

The other-staff-expenses category does not include the statutory salary-related expenses or general fringe benefits. These are described in Part 4 of this series.

Marketing expenses: Marketing is a crucial part of an architectural practice, and non-salary expenses related to marketing must be included in the budget. These costs cover proposal printing, travel (including meals and accommodations), client entertainment, 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 consists mostly of rent, utilities, and furniture and furnishings, including computer hardware and software. Rent is an example of a fixed cost that is known a year or more in advance. Lease amounts, along with the utilities and maintenance costs that go with them, are generally fixed for one or more years; budget estimating is thus fairly straightforward. Depreciation and amortization expenses for furniture and equipment 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 generally predictable. To estimate these expenses, compare a few years' worth of records against a base such as headcount, total salaries, or net revenues. This will likely show a pattern of consistency of proportion to one of these bases. That basis then facilitates the budget estimates.

Corporate expenses: Corporate expenses are those incurred on behalf of the firm as an entity. The largest expense in this category is professional liability insurance. Other corporate expenses include non-project-specific legal and accounting services, and other types of non-project-related consultants (such as a public relations consultant). A firm also may use this category for various business licenses and taxes.

Contingency funds

Once all the category expense totals are estimated and budgeted, the overall total is compared to net revenue, with the difference being the first estimate of operating profit 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 into the corporate expenses category, a contingency amount for unforeseen events or opportunities that may present themselves. An "Other" or "Misc." line item in each category's initial budget estimate can facilitate this.

Working capital requirements

Part of the budgeting process is determining working capital requirements. Working capital is defined as the difference between current assets and current liabilities, but essentially is the money needed to pay all operating expenses as they become due, and the time client payments are collected. Within the budgeting process, the working capital often comes in the form of profits from the current or previous years that are not paid out as bonuses or distributed to shareholders. These profits can also be supplemented by having a line of credit arranged with a bank. Particularly if growth is sought or expected, additional working capital is required.

Summary

In this five-part series we have covered the foundational concepts related to creating budgets and setting key performance indicators for a firm. Following these concepts will allow you to financially plan and track your progress in an industry-standard way. However, it is ultimately most important to focus on the performance of people and projects needed to make an operating profit that allows for the sustained operation of your firm. Profit is the result of the time and talents of a firm's people who provide the services a firm sells, meaning that architecture truly is a "people" business.

Developing company financial budgets: the five-part series

This Best Practice concludes a series of five articles addressing budget development for architectural firms:

- 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

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