AIA Best Practices:
Creating an annual budget for a large firm

Part 4 of Developing company financial budgets

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Summary

Parts one and two of *Developing company financial budgets*, established a firm foundation of budgeting basics and vocabulary. Part four covers how to set a budget for your company, with an emphasis on large firms (for small firms, refer to part 3). Large firms often face the increased complexity of multiple operating units. Thus, a large firm's budget should reflect not only the finances of the firm as a whole, but also each individual operating unit. If there is a significant disparity among the revenue-generating units, firm leaders should assess the reason for this disparity when they plan for the future.

Intrafirm analysis

Large firms often have multiple operating units, such as studios, departments, divisions, or practice areas, and need to analyze the performance of each unit. Just as Figures 4 and 5 in Part 3: Creating an annual budget for a small firm showed the year-to-year variances in overall firm metrics and profitability, Figures 7 and 8 (below) show the 2022 budget analysis for individual operating units. Figures 7 and 8 show such an analysis, again using the same sample P&L (Figure 1 from Part 1: Budgeting basics) and 2022 budget (Figure 5 from Part 3: Creating an annual budget for a small firm) we've seen in previous Best Practices in this series.

Figure 7: Basic income statement (by division)

	Unit 1	Unit 2	Unit 3	Unit 4	Admin	Total
Total Revenue	$25,000	$30,000	$35,000	$41,600	$0	$131,600
Direct Expenses	$7,900	$7,900	$7,900	$7,900	$0	$31,000
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
Overhead Allocation	$7,328	$7,328	$7,713	$7,713	($30,082)	$0
Operating Profit	($4,862)	$138	$4,062	$10,662	$0	$10,000

Figure 8: Key performance indicators (by division)

	Unit 1	Unit 2	Unit 3	Unit 4	Admin	Total
Total Labor	$11,083	$11,083	$11,667	$11,667	$9,166	$ 54,666
Total Labor + Payroll-Related Expenses	$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 Percentages	(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%	61.0%
Payroll Multiplier	1.54	1.99	2.32	2.89	n/a	1.83
OH Rate w/o Bonuses	164%	164%	177%	177%	n/a	170%

The figures above show a budget for five operational units. Four are revenue-producing, project-based units. Depending on how the firm is organized, these units might be, for example, separate offices (e.g., New York, Atlanta, Dallas, and San Francisco) or different practice areas (e.g., healthcare, education, corporate offices, and urban planning) or different client types (e.g., private, institutional, governmental, and international).

The fifth is an administrative unit, which includes overhead costs such as accounting, human resources, information technology, and marketing staff. Many overhead expenses such as facilities costs, computer hardware and software, insurance policies, and office supplies are in this category, as they are not usually recorded as expenses of the operating units.

The combined projects of Units 1 to 4 must generate enough revenue to cover not just their own project labor and expenses but also a proportionate share of overhead expenses. However, each unit doesn't budget for these expenses, except for special cases in which a specific unit is incurring specific overhead costs, such as certain equipment, its own office space, or its own marketing expenses. Nonetheless, to get a full picture of the contributions of each unit, a firm allocates all overhead costs to the units, proportionate to the total labor of each unit, because each unit should generate enough net revenue to cover its overhead share.

The result is that each unit becomes a profit center with its own overhead rate, its own operating profit rate, and, in essence, its own complete profit and loss (P&L) statement. The firm's overall P&L statement is nothing more than the sum, or "roll-up," of the individual units' P&L statements.

Comparing the units

Figures 7 and 8 show us the people (i.e., labor) costs and the operating metrics of each unit. The figures are structured such that, although the units serve different client or project types, each unit requires the same amount of direct labor for its projects. All four have budgeted direct labor of $8,333 and other indirect expenses of $1,500.

Units 1 and 2 have budgeted indirect labor of $2,750, giving them utilization rates of 75% and OH rates of 164%. Units 3 and 4, however, have indirect labor of $3,333, giving them utilization rates of 71% and OH rates of 177%. This difference can have many reasons, such as how much time is being dedicated to marketing, an indirect labor charge.

The most obvious differences between the units are the net revenue amounts they generate and the resulting net multipliers, given that each has the same amount of direct labor. Unit 1 is budgeted to operate at a loss of $4,862, with a 2.05 net multiplier that falls considerably short of its 2.64 breakeven rate (1.64 OH rate + 1.00). Unit 2 is budgeted to barely make a profit (0.6%), as its 2.70 net multiplier just slightly exceeds its 2.64 breakeven rate. Because they have been allocated more indirect labor, the largest component of overhead, than Units 1 and 2, Units 3 and 4 have lower utilization rates (71.4%), resulting in a higher breakeven rate of 2.77 (1.77 OH rate + 1.00). Nonetheless, with 3.30 and 3.90 net multipliers, they achieved 16% and 29% operating profit rates.

While the firm's overall 2022 budget looks financially strong, the disparity among its units is striking. Why would the firm budget one of its units (Unit 1) to operate at a significant loss, requiring the other units (especially Units 3 and 4) to perform exceptionally well to make up the difference? The firm can have many reasons: some good, others not so good. One good reason is that perhaps Unit 1 is taking on a new practice area or a new region and is in the early stages of building up its portfolio. Or maybe the unit has performed well in the past but is entering 2022 with several unprofitable projects that will be completed soon, leaving the hope that the unit will rebound in 2023. A third reason, not so good, is that the unit specializes in a practice area traditionally associated with the firm, which the firm is so far unwilling to abandon. Depending on the reason(s) for such poor anticipated Unit 1 performance, the firm may in the future consider discontinuing the unit if it doesn't turn itself around.

In the final Best Practice in this series, Part 5: Budgeting indirect expenses, we'll look at creating a budget for the firm's various operating expenses.

Developing company financial budgets: the five-part series

This Best Practice is the fourth in a series of five articles that address budget development for architectural firms. Each article builds on, but tries to not repeat, information provided in previous articles.

- 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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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