PRACTICE BULLETIN

PB-07-PART A

MAINTAINING PROFITABILITY HOURLY RATE

SUMMARY

This is the first in a series of Practice Bulletins that will address the issue of maintaining profitability in a firm. First, we will examine the hourly rate with tips that are useful when preparing client/Architect-Licensed Interior Designer agreements.

BACKGROUND

It is a misconception that profit is the only measure of the viability and success of a business endeavor. In reality, you can have all the profit in the world on paper, but without a coin in your pocket you are worthless. As many come to realize it is cash flow and not profit that is the key to success of a business. One element in the cash flow is the process of calculating the hourly rate for hourly billings. Many Architects and Licensed Interior Designers have used the various methodologies available to calculate hourly rates, which at its basic level is expressed as:

$$\frac{\text{SALARY}}{\text{TOTAL ANNUAL}} \times \text{FACTOR}$$

PRODUCTION

While this traditional method of taking a salary, adding a factor of 2.5 along with a straight correlation of production hours has been in use for many years, further examination can surprisingly reveal a rate higher than normal. One must fully understand what is involved in calculating these numbers and of converting salary to Direct Personal Expense.

WHAT IS DIRECT PERSONAL EXPENSE?

The Direct Personal Expense (DPE) includes the base salary, including bonuses (but not profit sharing), Employment Insurance (EI), Canada Pension Plan (CPP), Group Insurance and any other benefits or financial plans. Make sure you include the employer's contributions toward EI and CPP. These other factors are often referred to as the "Payroll Burden". You will find that these typically will run between 15% and 20% of the basic salary. Some choose to add the cost to the firm of overtime, vacation and statutory holidays. This is acceptable provided the total hours are *added* to the total annual production hours. The recommendation is not to include them and factor it into the hourly rate. For the sake of simplicity we will use 20%; in fact you will find that this is an acceptable factor to determine the DPE. You may also wish to consult with your accountant.

HOW DO YOU CALCULATE THE TOTAL ANNUAL PRODUCTION HOURS?

For the calculations that follow, our model is based on a 36 hour-work week. 52 weeks would result in 1,872 hours. Deductions should be made as follows:

• 3 weeks vacation 3 x 36	108
• 10 Statutory Holidays 10 x 8	80
	188

At first glance, it would appear that the Total Annual Production Hours would equal 1,872 less 188 would equal 1,684. You should also include any time off given by the firm such additional days around Christmas that is not banked or taken in lieu of. Here is where closer examination can reveal factors perhaps not considered before.

OTHER FACTORS

Not every employee will work exactly 1,872 hrs; one factor is sick time (it is assumed that your firm will pay for some sick time). A good rule of thumb if you do not have accurate figures is to allow 1 week or in the case of our model, 36 hrs. Also, an employee working at 100% efficiency is also unrealistic. There is time spent on non-billable work such as promotion, computer maintenance, general office and the like. Again, you may wish to examine timesheets to get an accurate picture, so for the sake of our model we will assume that the "downtime" or non-billable time is 15%. Here is where the cost of doing business can easily get out of control.

Firms should maintain good management controls to reduce the amount of time that an employee is non-billable. Now let's re-examine our production hours.

- 1 week of sick time 36
- Non- billable time <u>248</u>

284

This means that out of a total of 1,872 hours, there is only 1,400 productive hours. A reduction of 25%!

Using these basic figures let's look at an example; the following represents an hourly rate for an employee earning $40,000 per year. The 1.2 factor in the following calculation is the extrapolation of 20% discussed earlier so that you can add the “payroll burden” to your rate.

- 40,000 x 1.2 x 2.5 / 1,400 = $85.71/hr

The factor of 2.5 is traditionally expressed as 1 (40%) for base expense of staff costs, 1 (40%) as overhead and 0.5 (20%) as profit.

Now let's compare the above example of $85.71/hr with the oversimplified formula discussed in the earlier calculation that did not take into consideration the refinements made:

- 40,000 x 2.5 / 1,872 = $53.42/hr

This illustrates the importance of accurately calculating, as there is a significant difference between the two rates.

The Alberta Association of Architects
Duggan House | 10515 Saskatchewan Drive | Edmonton, AB T6E 4S1
Ph: 780-432-0224 | Fax: 780-439-1431 | Email: Practiceadvisor@aaa.ab.ca | www.aaa.ab.ca

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HOW TO NEGOTIATE THE HOURLY RATE

As many of you will be aware negotiating hourly rates is a chore and often an unbearable task with a client. From experience many have found that it is best to discuss the hourly rates and make the client aware of them up front when the Agreement is being negotiated. Try to avoid going into too much detail, avoid repercussions later by using the method here, a derivative or some other method.

It is not recommended to list the formula or methodology used to calculate the hourly rate.

List all the hourly rates for Principal, Architect/Licensed Interior Designer, Technologist, support, etc. within the agreement. A good location for this is where additional services are discussed, as often (except for a time-based fee) this is where the rate comes into effect.

If you have two technologists who compare in experience and skills but have different rates, simply average the two and use that figure. Time can be lost when a client argues over an invoice where they feel they should be charged for technologist Y at $48/hr and not technologist Z at $50/hr. The net difference between the two will not be a factor in the long run.

You will find if you have to undertake an additional service, which is clearly identified in the agreement and has been discussed with the client, this will reduce the debate at invoicing. However, the reality is that most clients will debate it. A good suggestion made by some seasoned practitioners is that ***always*** bill additional services separate from regular billings based on the agreed fee and to alert the client in advance that additional services are required. This will prevent a resulting negative cash flow when your regular, agreement based invoice is held up to discuss the additional service.

When negotiating a fee, reimbursement for additional services should be given equal consideration. In addition, make sure that you update the rates every time there is a change in salary and at least every year, build this update into your agreements by stating that the rate is only in effect for **x** months or will be updated at a specific date.

NOTES

The *Alberta Association of Architects* thanks Barbara Komisar for kindly providing this article. Ms. Komisar is a lawyer with *Ogilvie and Company* and practices in the areas of corporate and commercial law.
December, 1995

Revised:
2012 – Practice Advisory Committee

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