

PB-07-PART B

MAINTAINING PROFITABILITY UNDERSTANDING OVERHEAD

SUMMARY

Architects and Licensed Interior Designers often have difficulty understanding overhead. It is the single most important element in business planning and when deducted from a gross fee, provides the firm with its profit. This Practice Bulletin looks at this facet of business and how a few basic approaches can help a practice maintain fiscal control and not spiral out of control.

The difficult but crucial task of identifying and controlling overhead is the fiscal planning of a practice. Many Architects/Licensed Interior Designers fail to understand it, yet it's really very easy; overhead is simply the cost to a firm of doing business. Many however, would be the first to agree that detailed explanations seem complicated especially when you calculated overhead as a percentage to arrive at the hourly rate billing method.

At its simplest of levels "Overhead" is every item paid out by a practicing office. To offset overhead, an office must generate income. It is clear, that, in order to maintain profitability one hopes that latter exceeds the former, so that a practice gains profit. This is simple enough, but now comes the more difficult part of expressing overhead as an hourly rate, or as a percentage cost to a productive cost. Once this is calculated, and a practice is comfortable with the methodology, fiscal control can be implemented, especially for percentage and lump sum fees.

Overhead can be calculated in various ways. Our intention is to discuss only one which has been found, after years of experience, to be the most cost efficient and helpful in fiscal control.

It's extremely difficult to accurately forecast what percentage current overhead will be, so the only alternative is to use historical facts. Year-end statements, audited or un-audited will serve the purpose for this model. For a large office, it may take some months to complete the process after year-end statements are finalized, further weakening the accuracy of the current overhead as a percentage. In other words, this method always has the overhead calculation in arrears but at least it's fairly realistic as long as overhead is closely monitored. Since we know overhead is supported by income generated by productive personnel, calculating overhead as a percentage is simple. The total cost of any operation, including all salaries paid is identified in the year end statements. By deducting productive personnel salaries from the total, one can quickly establish the overhead as a percentage. We must emphasize "productive personnel." This refers to all staff that produces basic information for a project and normally does not include assistants, receptionists, accounting personnel, etc. Partners must decide whether they fit the productive or non-productive component, in a practice where the partners rely on profit-only reimbursement, it is generally recommended that they be included in the productive category, for a salary equal to the highest paid employee in that category.

For example, assume an office has a total expense of \$500,000, \$250,000 of which represents salaries paid to productive personnel, including partner's time be it actual or an allowance.

Overhead would be simply stated as:

$$\frac{\text{Total Office Cost-Productive Salaries}}{\text{Productive Salaries}} = \text{Overhead}$$

Or

$$\frac{(\$500,000 - \$250,000)}{\$250,000} = \frac{\$250,000}{\$250,000} = 1 \text{ or } 100\%$$

Now, if you can examine this critically, a more realistic overhead can be established. (In doing this, one should ignore the calculation of the hourly rate in Practice Bulletin 07-Part A)

In the operation cost of \$500,000, one could have reimbursable expenses - those reimbursed directly from a client. These may amount to \$10,000 and should be deducted from the expense of operation. The most critical area to be reviewed is the salaries paid and the component referred to as downtime, that time in each employee's normal working year that is not spent productively. In calculating hourly rates, the normal working time of an employee is 1,950 hours, that is 52 weeks x 37.5 (7.5 hours per day, 9:00 am to 5:30 pm, less one hour for lunch). Already established in Practice Bulletin 07 Part A is the method of hourly rate calculation, the actual productive hours for charge out time amounts usually to only 1,725. As a percentage, the reduction is best expressed as:

$$\frac{1,950 - 1,725}{1,950} = \frac{225}{1,950} = 11.54\%$$

When you carefully review productive hours it is amazing to find that the average productive time spent of the remaining 1,725 hours is around 1,400. Time is usually lost due to lack of work, time spent preparing proposals for future work. So, if one takes average production as only 1400 hours per year employee from the original 1,950 hours this means productive staff is only efficient:

$$\frac{1,400}{1,950} = 71.8\%$$

The balance of 28.2% is downtime. While this will differ from employee to employee, one must assume this generally applies to all staff employed on a productive basis.

It is now opportune to explore the original assumption of \$500,000 office expense, and \$250,000 staff salaries (productive personnel) with the two adjustments referred as:

- \$10,000 reimbursable expenses
- Efficiency factor of staff salaries of 71.8%

The overhead figure could now be expressed as:

$$\frac{\text{Office cost - reimbursable expenses - (250,000 x efficiency Factor of productive salaries)}}{\text{Office Salaries}}$$

This would be interpreted as:

$$\frac{\$500,000 - \$10,000 - (\$250,000 - \text{efficiency factor } 71.8\%)}{\$250,000}$$

$$\frac{\$500,000 - 10,000 - \$179,500}{\$250,000}$$

$$\frac{\$310,500}{\$250,000} = 1,242 \text{ or } 124,2\%$$

Clearly, what appeared to be 100% overhead is actually closer to 124%. This becomes critical in calculating allocation of hours from a fee, or indeed calculating a fixed fee. The importance of an estimated overhead factor and the establishment of a true overhead factor in the fiscal control of an office by the foregoing should now be better understood.

The importance of regularly monitoring overhead must also be recognized. The use of historical facts is only true statement of the past year of operation. In affluent times, downtime can be improved upon, but in adverse time, downtime may increase and have an even larger impact on the overhead. Clearly the larger the office, the greater importance control will have. We recommend a thorough quarterly analysis of figures. We can't stress enough the importance of any office understanding the impact overhead has on a practice, as well as how a practice is affected if constant control is not exerted.

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.
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