Financial Management - Beyond Intuition
Part Two: Profit Planning

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Can you actually plan to make a profit?

As we discussed in Part 1 of this article (Licensed Architect Volume 18, No. 4 - Winter 2014), financial management involves tracking key financial indicators pertinent to firm financial health and using the information to forecast likely future performance. In Part 2 we will discuss how to calculate billing rates to ensure that your projects at least have a chance at profitability. In addition, you will find out how expense budgets and net revenue forecasts can help you make strategic business decisions, even in an unpredictable economic environment.

Billing Rates and Profit Planning

Now we come to the really exciting information about how to plan for profitability on projects. Profitability depends on the relationship between your break-even ratio and the billing rate charged to clients. This is expressed as a billing multiple, which is the factor that is multiplied times the hourly cost rate of an employee (or owner) to determine the amount charged per hour to a client (billing rate). It makes no difference if you charge clients on a fixed fee or hourly basis. The effort still needs to be tracked on an hourly basis to know where you are in relation to a project budget.

Your billing multiple must be greater than your break-even ratio if you want to make a profit. You can calculate the break-even hourly rate for each staff member (and owner) by multiplying their hourly cost rate (cost rate = salary ÷ 2080 hours for full time) times the firm's break-even ratio.

Example:

- RK's Full-time Salary: $70,000
- Cost Rate: $33.65/hr ($70,000 ÷ 2080 hours)
- You know the firm's break-even ratio is 2.80
- RK's break-even billing rate: $33.65 times 2.80 = $94.22/hour, round up to $95/hr.

This is how much you must charge hourly for RKs work, simply to break even. Now, to add a profit factor, you divide the break-even billing rate by the complement of your profit goal. So, if your profit goal is 20% then:

- RK's billing rate with 20% profit factor: $94.22 ÷ .80 = $117.77/hour, round up to $120/hr.

- RK's billing multiple: $120 ÷ $33.65 = 3.56

This means, to make a 20% profit on RK's work, RK's billing rate must be 3.5 times RK's hourly cost rate.

To help you to build in profit when estimating fees for a project proposal, consider the following process:

1. Figure the fee bottom-up, based on the hours and staff needed for the effort. Price the fee based on break-even billing rates to determine the absolute bottom line – the fee you must obtain to simply break-even on the project.

2. Refigure the fee at the billing rates that include a 20% profit. This will give you a total fee amount that includes a reasonable profit. This is not meant to replace a contingency, it is meant to give you a fee that will result in a reasonable profit.

3. Compare each fee total to the market value of the services from the client's point of view, or any other top-down metric, such as a reasonable percentage of the estimated construction costs.

This process will give you information you need to decide on a competitive fee that is likely to earn you some profit. It can also prevent you from proposing fees that won't even allow you to cover your overhead and salary expense on the job. If you decide to take on a job that you know is a money loser, there should be a very good reason.

Budgets and Revenue Forecasting

For the last piece of the financial management puzzle, it would be helpful if we all had a crystal ball that allows us to peer into the future. Lacking that tool, we have to rely on trends from past performance to give us a clue about what might happen in the future.

For expense budgets, this is fairly straightforward. Most overhead expenses stay fairly stable year to year, with the notable exception of healthcare costs. Overhead costs tend to go up in sudden steps, rather than in a smooth linear fashion. Growing the firm to a point where an office move is required is an example of a stair-step change in overhead and a firm in transition may have a harder time forecasting its overhead expenses. The best practice is to start with an expense budget that is divided into fixed expenses – those that are the same month-to-month and variable expenses – those that change each month due to discretion and changing operational needs of the firm.

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Revenue forecasting can be equally simple, although less reliable and predictable. Start with jobs under contract, deduct any amounts that will be going to outside consultants, and note the amount remaining yet unbilled. The total is known as your "backlog."

Then add up your "prospects" – the total amount of proposals outstanding, minus any amount that will go to outside consultants. Last, consider any possible "suspects," – proposals outstanding with a slim chance of success, conversations that may lead to a project, etc., and try to estimate the value of these possibilities.

To arrive at the net revenue forecast, each total is adjusted to reflect likely outcomes based on common sense and historical firm data, if available. Typically the revenue forecast is calculated as follows: [backlog x 90%] + [prospects x 50%] + [suspects x 10%]. You can set up a spreadsheet to track your revenue forecast as jobs are completed, prospects become backlog and new prospects and suspects emerge.

It is good practice to prepare an annual budget with the net revenue forecast and a list of operating expenses that is as complete as possible. With historical data, you can develop a budget that outlines expenses by the month and then compare it to actual expenses as the year progresses. Doing this will help you make decisions about issues such as how much to spend on marketing and business development or discretionary benefits for staff, and it will provide a host of other information to help you run your firm smarter.

Financial management can be done quickly and effectively once tools are in place to automate many of its processes. It is possible to set up dashboards and spreadsheet tools to track key financial indicators. Electronic time sheets that sync with spreadsheet software are easily available. And software products such as BillQuick and Ajera by Axium (recently acquired by Deltek) may also be an option, especially for firms approaching 15 people in size.

Financial management, along with clarity of purpose and a sound marketing plan, is critical to a creating a successful practice.

About the Author
Rena M. Klein, FAIA is the author of The Architect's Guide to Small Firm Management (Wiley, 2010) and principal of RM Klein Consulting, a firm that specializes in helping small firm owners run their firms better.