



**AIA**  
Florida

Provider #: A022

## Fee Negotiation Tips and Techniques Panel Discussion

Course Number: CN17FNT



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Questions related to specific materials, methods, and services will be addressed at the conclusion of this presentation.



# Course Description

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Inform and discuss the various methods available in providing architectural/engineering services for the client. Inform and discuss various methods of applying fee structures for the services provided. Discuss the importance of defining the Scope of services.

# Learning Objectives

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At the end of the this course, participants will be able to:

- Discuss the importance of defining the Scope of Services
- Discuss the different types of services provided by the Architect/Engineers.
- Methods of establishing fees for projects. Types of contracts available for various projects Joint venture projects
- Discuss the contractual phases of the project, i.e., pre-contract site investigation, feasibility studies, conceptual phase, schematic design phase, design development phase, construction document phase, bidding phase, construction administration phase and post construction phase, LEED, etc. How to determine % of fee for each of the various phases of work to be performed. How to allocate fee into the various phases of work.



# Bob's Pretty Good Architectural Firm

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G Neil Harper

# Getting Started

- On December 31, 2004, Bob opens a bank account, and deposits \$10,000 to get his firm started.

## Balance Sheet 12/31/04

■ Assets	
■ Cash	10,000
■ Total Assets	10,000
■ Liabilities	0
■ Net Worth	
■ Shareholders' Equity	10,000
■ Total Liabilities & Net Worth	10,000

## Setting Up Shop

- 1. Bob very quickly gets his first project: to design a luxury home (projected cost of \$3 MM, with a 10% fee = \$300,000).
- 2. He decides to pay himself \$100,000 per year
- 3. In the first year he has been busy promoting his firm and getting his office set up. But he has been able to work 1248 hours on the project.



## Chargeable Ratio:

- Bob's chargeable ratio
- = direct hours charged to project / total hours worked
- =  $1248 / 2080 \times 100 = 60\%$
- Thus 60% of Bob's salary is direct labor charged to project:
- =  $.60 \times \$100,000 = \$60,000$

## Overhead Rate

- During course of year, Bob pays office rent, contracts with a service to buy secretarial assistance, buys supplies, pays for promotional materials, attends a couple of seminars, and does a good bit of travel to promote his firm. Total cost in the first year: \$60,000 office expenses, plus \$5,000 depreciation on his new computer and office furniture
- Note that 40% of his time has been spend on these indirect activities, so \$40,000 of cost has been charged to overhead.
- Total Overhead costs = \$65,000 + \$40,000 = \$105,000
- Overhead Rate = Total Overhead Costs / Direct Labor Cost
- = 105,000 / 60,000 = 175%

## Effective Multiplier

- Bob knows that he must cover both his direct salary and his overhead costs. He has agreed with his client that he will charge three times his direct salary costs for his services. Recall that he has charged \$60,000 of direct salary to the project.
- Revenue in first year =  $3 \times \$60,000 = \$180,000$
- Effective Multiplier = Total Revenue / Direct Labor Cost
- $= \$180,000 / \$60,000 = 3.00$

## Income Statement for Period 1/1/05 - 12/31/05

■	Revenue		180,000
■	Direct Expense		
■	Labor		60,000
■	Indirect Expense		
■	Labor	40,000	
■	Office	60,000	
■	Depreciation	5,000	
■	Total Indirect Expense		105,000
■	Profit		15,000

## Additional Activities in First Year

- 1. To furnish his office, Bob bought a computer system, some office furniture, and made some leasehold improvements to his rented space. Total investment: \$25,000
- 2. To help finance these investments, he got a loan from his bank. Bank loan: \$10,000
- 3. At the end of the year, Bob's client still owed him the last two months' invoices: Total outstanding: 30,000
- 4. Because he was running low on cash, he was also holding some bills in his desk drawer for secretarial services, rent, and travel expenses. Total owed: \$16,000

## Balance Sheet

■	As of 12/31/05		■	As of 12/31/04	
■	Assets		■	Assets	
■	Cash	1,000	■	Cash	10,000
■	Accounts Rec'ble	30,000			
■	Plant & Equip	25,000			
■	Less Depreciation	-5,000			
■	Total Assets	51,000	■	Total Assets	10,000
■	Liabilities		■	Liabilities	
■	Accts Payable	16,000			
■	Bank Loan	10,000			
■	Total Liabilities	26,000			
■	Net Worth		■	Net Worth	
■	Shareholders' Eq	10,000	■	Shareholders Eq	10,000
■	Retained Earn	15,000			
■	Total Net Worth	25,000			
■	Total Liab & N.W.	51,000	■	Total Liab & NW	10,000

## What Happened to the Cash ?

- At this point, Bob was happy. He had gotten his office started, and had a satisfied client.
- He had also turned a profit in his first year of operations.
- He started out the year with \$10,000 of cash, and had made a profit of \$15,000.
- But he was feeling pressed; he had only \$1,000 in his checking account.
- What had happened to his cash?

## Cash Flow Statement for period 1/1/05 - 12/31/05

■	Operating Profit	15,000
■	less increase in Accts Receivable	-30,000
■	plus depreciation	5,000
■	plus increase in Accts Payable	16,000
■	Total from Operations:	6,000
■	Investing Activities	
■	purchase of equipment	-25,000
■	Total from Investing:	-25,000
■	Financing Activities	
■	proceeds from bank loan	10,000
■	Total from Financing	10,000
■	Total change in cash	-9,000
■	Cash at beginning of period:	10,000
■	Cash at end of period	1,000



## So What Has Bob Learned ?

- Bob now felt that he had a pretty good handle on how things were going. He had used and understood three critical indicators that are peculiar to architectural practice:
  - ◆ Chargeable Ratio
  - ◆ Effective Multiplier
  - ◆ Overhead Rate
- And he had also learned the importance of the three standard financial statements that every firm must have:
  - ◆ Balance Sheet
  - ◆ Income Statement
  - ◆ Cash Flow Statement
- But still, he wondered: Are there some other critical financial indicators that I should be monitoring as my young practice begins to grow? And he wondered how he compared to other firms in the profession.

## 8 Financial Indicators to Watch:

	Bob's	2005 Industry Survey
<b>Chargeable Ratio %</b> = Total Direct Hours / Total Hrs Worked	60 %	64 %
<b>Effective Multiplier</b> = (Earned Revenue – (Reimb + Direct NonLabor Exp)) / Direct Labor	3.00	2.99
<b>Overhead Rate %</b> = Total Indirect Expenses / Total Direct Labor	175%	152 %
<b>Direct Personnel Expense Factor %</b> = Total cost of all employee benefits / Total cost of “hours worked”		132.6 %
<b>Pre-Tax Profit %</b> = Profit before Tax / Gross Revenue	8.33 %	4.14 %
<b>Average Age of Accts Receivable (Days)</b> = Accounts Receivable / Average Billing per Day	61 days	77 days
<b>Net Revenue per Total Employee</b> = (Earned Revenue – (Reimb + Direct NonLabor Exp)) / Total Number of Employees	\$180,000	\$103,000
<b>Capital Investment per Employee</b> = Total Assets / Total Number of Employees	\$51,000	\$47,210

## Accounting Mistake Made by Many Architecture and Engineering Firms

### Executive Overview

Few of us have taken any accounting courses and even fewer have taken the time to earn an MBA. So when it comes to the accounting side of running our business it most likely is not our strong suit. We also tend to rely on our accounting software to do the dirty work for us.

Since the huge majority of AE firms are small businesses they have chosen to use the number one small business accounting software, QuickBooks. According to surveys done by PSMJ nearly 80% of AE firms in the United States are using QuickBooks.

When QuickBooks creates the accounts for a new company using the template for Architects and Engineers it fails to set up what is needed and the mistake is already made. Read on to discover what the mistake is, why you should care, and how to correct it.

### Only One Account for Payroll Expenses

When QuickBooks sets up the Chart of Accounts it creates a single expense account for all of your payroll expenses. The challenge with this is you can't separate your direct costs from your indirect costs (overhead).

With this set up there is no way to calculate three critical factors:

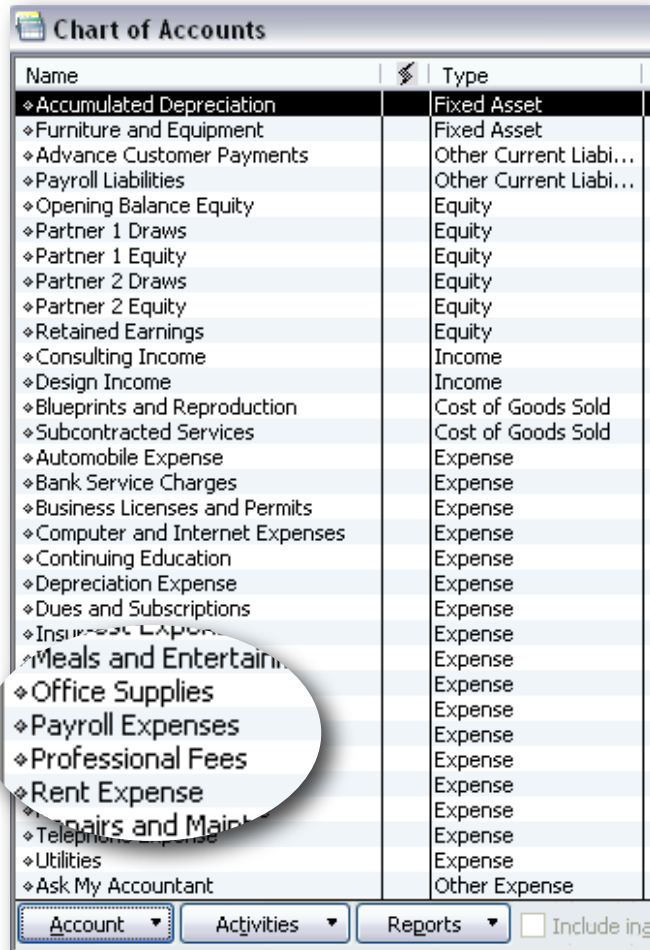
- Overhead Rate – the number of dollars of overhead for every dollar of direct labor.
- Billing Multiplier – net revenues divided by direct labor
- Utilization Rate – direct labor divided by total labor

### Second Account for Overhead Payroll

You will need to create a second expense account to track indirect labor payroll costs. These include all of the other payroll expenses including Taxes, Benefits, Holiday, Vacation, PTO, Medical, etc.

But don't stop there. You also need to include overhead labor for Marketing, Business Development, Continuing Education, Accounting, Administration, etc. The labor costs for these activities are overhead. Once you have a second account set up you will be able to generate your critical factors.

Depending upon how you manage your fees and whether or not you have sub-consultants you may elect to have your Direct Labor be a Cost of Goods Sold rather than an Expense.



Name	Type
Accumulated Depreciation	Fixed Asset
Furniture and Equipment	Fixed Asset
Advance Customer Payments	Other Current Liabi...
Payroll Liabilities	Other Current Liabi...
Opening Balance Equity	Equity
Partner 1 Draws	Equity
Partner 1 Equity	Equity
Partner 2 Draws	Equity
Partner 2 Equity	Equity
Retained Earnings	Equity
Consulting Income	Income
Design Income	Income
Blueprints and Reproduction	Cost of Goods Sold
Subcontracted Services	Cost of Goods Sold
Automobile Expense	Expense
Bank Service Charges	Expense
Business Licenses and Permits	Expense
Computer and Internet Expenses	Expense
Continuing Education	Expense
Depreciation Expense	Expense
Dues and Subscriptions	Expense
Insurance Expense	Expense
Meals and Entertainment	Expense
Office Supplies	Expense
Payroll Expenses	Expense
Professional Fees	Expense
Rent Expense	Expense
Repairs and Maintenance	Expense
Telephone Expense	Expense
Utilities	Expense
Ask My Accountant	Other Expense

## The Importance of Net Fee

Calculating and utilizing your net fee enables you to measure all of your projects on an even playing field. It also allows you to look at national averages and compare your firm to others regardless of discipline.

You see, if you have sub-consultants for most of your projects as part of your gross fee and you calculate your profit as a percentage of the gross fee you are misleading yourself to believe that your profit percentage is rather low. Then you have a project where the sub-consultants contract directly with the owner so your gross fee is much less and you will see a much higher net profit percentage.

By removing the sub-consultants and reimbursable items from the equation you get a much more accurate view of your performance.

This also allows for firms who have a great number of sub-consultants to compare their ratios to firms who have few sub-consultants or none at all.

## Overhead Rate and Why It Is Important

Your Overhead Rate is a very simple calculation. Add your Indirect Labor and General Expenses together. This is your total indirect or overhead cost. Then divide this number by your Direct Labor to get your Overhead Rate.

### Caution!

When you calculate your Indirect Rate, or any other value for that matter, you must use 12 months of data. This enables your annual expenses to get evenly distributed. Any running 12 month period will do, you are not limited to a calendar year. In fact it is best to use the previous 12 months.

The national average in the United States is around \$1.53. So for every dollar of direct labor that is charged to a project, a \$1.53 in overhead is also attributed.

## Getting to Your Net Fee and Profit

There are at least a couple of opinions about what your net fee equals. For the purpose of this document we will use the following:

<b>Gross Revenue</b>	(your billings or fees)
<b>- Reimbursables</b>	(subtract these expenses)
<b>- Sub Consultants</b>	(not your money)
<b>Net Fee</b>	(also known as Net Revenue)
<b>- Direct Expenses</b>	(printing, postage, travel, etc.)
<b>- Direct Labor</b>	(cost to do the work)
<b>Gross Profit</b>	(a starting point)
<b>- Indirect Labor</b>	(admin, marketing, etc.)
<b>- General Expenses</b>	(cost to keep doors open)
<b>Operating Profit</b>	(What you made)

Others methods will have you move the Direct Expenses above the Net Fee. I personally like to look at my profits as a percentage of Net Fee to measure our success. In other words, of the money that is ours to work with, what percentage is reaching our bottom line.

### Quick Calculation for a Project

Project Fee	\$100,000
- Reimbursables	\$2,000
- Sub Consultants	\$40,000
Net Fee	\$68,000
- Direct Expenses	\$3,000
- Direct Labor	\$22,900
Gross Profit	\$42,100
- Overhead Factor	\$35,000
Project Net Profit	\$7,100

This project might look great if all you see is the Gross Profit, but once you subtract the Overhead Factor you end up with a Net Profits of only \$7,100 which is a Net Percentage of only 10.4%.

Here is where using the overhead factor gets to be fun. With this number you can now calculate the Net Profit for any given project. You can also categorize your projects in summary reports to identify where your best performers lie. Take a look at the insert to the left.

QuickBooks along with many other accounting software packages does not have a way to account for overhead. So QuickBooks can not tell you what your net profits are for a give project or category of projects.

The calculation to the left can and should also be ran on groups of projects. You should look at your project in several different categories such as building type, occupancy, fee structure, location or region, delivery method (design-build vs. plan spec.), private versus public, etc.

With this information you can knowingly target the projects that generate the highest profits for your firm.

### Billing Multiplier

Like the Overhead Rate in the previous section this is an important number to use when evaluating the health of your firm and success of your projects. This number is a simple calculation of your Net Fee divided by your Direct Labor. The national average for this number is between a little below to a little above 3. So for every dollar of direct labor there should be around three dollars of Net Fee.

Using this number you can calculate your earned value, or supposed earned value for a project. If a project has \$1,000 in direct labor charged to it, then around \$3,000 of fee has been earned. Not for it to be earned you would have had to have made progress on the project. If this project has a total fee of \$10,000 then you would need to be 30% complete to be on schedule and on target.

#### It all comes full circle

If your overhead rate is 1.5 and your profit target is 20% then what does your Billing Multiplier need to be? Take your direct rate of 1 and add your overhead rate of 1.5 then divide by 80% (100% - 20%). This gives you  $2.5 \div .80 = 3.125$

Just like I encouraged you to do with your Overhead Rate, you need to calculate your Billing Multiplier for all of your project segments. Armed with this information you will know exactly where to target your marketing and which clients or project types must be avoided.

### Utilization Rate

Here is another number that is a simple to calculate. Take your Direct Labor and divide it by your Total Labor (Direct Labor plus Indirect Labor). This will tell you what percentage of your labor costs are going to generating revenue. How effective your team is.

Now, this can not be calculated for projects because we are comparing project direct costs to overhead costs. But you can use this to compare divisions or studios. Since I have targeted this

paper towards small firms you may not have the various groups to measure. But you can measure your firm as a whole and you can look at individuals to see how they are spending their time.

In my experience, healthy firms run between 65% and 75%. This means that the majority of their labor costs are attributed to production. If they fall below these numbers they are in danger of becoming non-profitable.

Having a utilization rate above 80% usually means that not enough time is being dedicated to marketing, education, and other administrative tasks. Note that it is impossible to hit 100% because of holidays, vacations, and other benefits.

You may have a group of production personal who are in the 80's but you will also have administrative staff in the low teens.

### **Conclusion**

None of these very important indicators can be calculated if you have only one payroll expense account. These numbers are the life blood of your firms and should be studied carefully and often. Keep your project managers in the know so they are aware of where their projects stand.

To stay up on these reports you will need to routinely export your numbers out of QuickBooks and into a spreadsheet where you can run the calculations. While this can become tedious, it is necessary.

Our practice and project management software, Praesto AE, integrates with QuickBooks does this work for you. For more information about our solutions we can be reached as noted below.

## **About Base Builders**

Founded in 2002, Base Builders is the company that brings you innovative Practice and Project Management software solutions. Our goal is to simplify your operational management, increase project management effectiveness, improve profitability and enhance client relations. For more information about our products, please visit [www.basebuilders.com](http://www.basebuilders.com).

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**Change over time**

- from state supported,
- to patron supported,
- to percentage of construction cost,
- to cost-based fees

**History: Why Architects Don't Charge Enough**

- 1861 5% of construction cost established as fee, resulting from Richard Morris Hunt lawsuit  
Set precedent separating architecture as profession from construction trades
- 1866 5% set as fee on AIA's "Schedule of Charges"
- 1888 Hubert v. Aitken: Technical knowledge is a reasonable requirement of an architect
- 1889 Coombs v. Beede: In addition to technical skill, architects have to possess the aesthetic sense and capacity to make decisions on the client's behalf
- 1908 AIA raises standard fee to 6%
- 1928 "The strange timidity that Architects display in informing clients of their charges and their willingness to go forward without any understanding whatever, are disreputable to them as men of affairs. Such conduct leads to misunderstandings, disputes, and litigation."
- 1951 Local AIA Chapters publish fee schedules
- 1966 AIA study: "The Economics of Architectural Practice", "the average architect loses money on one job out of four".  
4/5 of firms used % of construction cost fees
- 1972 Consent Decree: Antitrust  
Led to move to cost-based compensation
- 1984 AIA Chicago issued compensation and fee policy statement
- 1990 Second Consent Decree
- 1999 AIArchitect study: "Over a quarter of firms indicated that only about half the time do fees reflect the actual amount of work actually expended."

**Context**

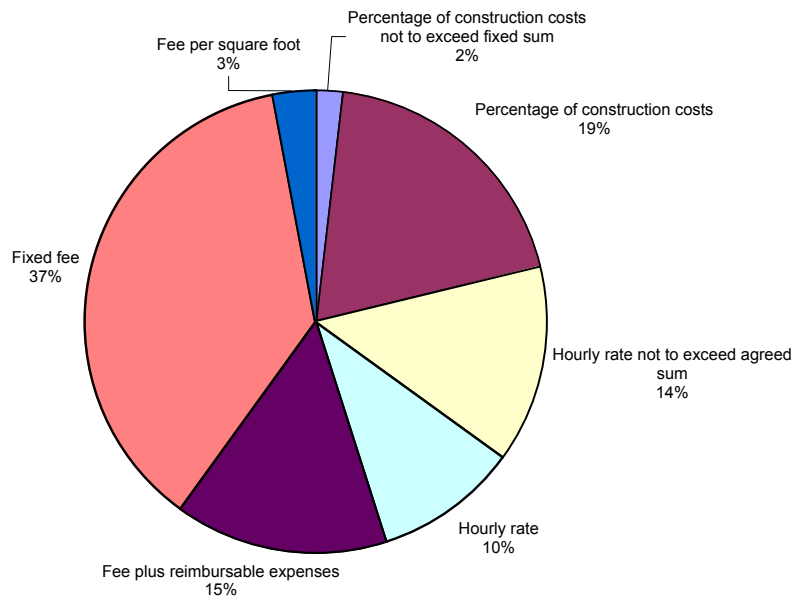
3 primary reasons for architects unwillingness or inability to obtain good fees

1. Unwilling to walk away from a great commission
  2. Lack business training, negotiating skills, or an understanding of real costs
  3. Have difficulty explaining the value of what we do
- Traditional emphasis on cost-based compensation has contributed to low profitability
  - Architects undersell their services
  - Stiff competition often lowers fees
  - Firms need to overcome being seen as a commodity service
  - Architects bring value to projects, and should be paid based on that value

**Trends**

- Architects are recognizing the importance of maintaining long-term client accounts, thus flexible compensation terms are devised to cover many different services, projects, and locations
- Alternative delivery methods require new combinations of architectural services and fees
- Different service approaches present different risks, which compensation should reward
- Client's needs do not begin with programming and end with construction
- Diversification of services has led to increased complexity of definition and pricing of services

**Fixed Fee Continues, (1999) to be Most Popular  
Contracting Method for Design Services**



**Compared to 1993:**

**How 100 surveyed structured their contracts:**  
 (Architectural Record, July 1993)

Slightly less than 1/2 of firms: Used only % of const. cost

Hourly rates

	Low	Ave.	High
Houses	\$30	75	120
Commercial	45	60	90
Educational	40	65	120
Industrial	45	55	70

% of Construction Costs for full services

	Low	Ave.	High
Houses	6%	10	15
Commercial	3.5	5	8
Educational	4	6	10
Industrial	3	4	6



**STEPS IN DETERMINING COMPENSATION****1. Consult with the client about needs and priorities**Client-generated work scope

Detailed service requirements as part of a RFP

Usual for repetitive or standard assignments

Detailed RFP's may specify program requirements, site conditions, service expectations, required deliverables, and schedules

Owner-architect agreements

Standard service agreements are useful for defining architectural services

Primarily for traditional design and construction projects

Owner and Architect can "select from menu", B141

Owner and Architect can agree to "package" of services, B141

Customized work plans and scope descriptions

For a set of special services, it is up to the architect to create a custom definition

Common Elements:

Client goals and objectives for the architect's services

Service tasks and expected work products

Key review and decision milestones

Schedules of tasks, phases, and milestone dates

Requirements for information or services provided by others

Allowances for changes or events outside the architect's control

Exclusion and additional services available if needed

**2. Identify service strategy, team, and work scope**

Multiple services over time, or one-time project specific services

What services, by whom?

What consultants and outside resources will be necessary?

**3. Estimate the cost of providing the services**

Prepare a project budget

Compensation worksheets/programs are useful tools

Who, what, when, where, how,.....and how much will it cost?

**4. Evaluate risk factors and apply an appropriate contingency**

Fundamental risk: Misunderstanding what is included in the architect's services

Specific risks

- Client decision-making and approvals
- Scope changes
- Third-party project managements
- Fast-tracking and construction-driven delivery schedules
- Construction cost responsibility and contingency structure
- Expected standard of care in design and technical coordination
- Financial resources and payment terms

**5. Assess the firms' value position and add the appropriate profit terms**Value positions

(Think back to Sparks model)

Design preeminence

Building type expertise and experience

Project leadership capability

Unique service methods and tools

Some possible valuable contributions

Increased sales in a retail environment

Decreased occupancy costs

Increase leases

Increased membership, usage, visitors

Increased productivity

- Plan for at least a minimum profit target
- Know the firm's competitive position and price accordingly
- Assess the value of the project to the firm

**6. Compare the proposal with the firm's past experience**

Most firms take an early educated guess about basic design service fees based on % of const. Cost  
Firms should track history of fee earnings and profitability as resource

**7. Written Proposal**

- Description of services covered by proposal
- Time schedule for the proposed services
- Identification of key team members
- Proposed compensation terms
- Assumptions and qualifications upon which the proposal is based
- Proposed form of agreement for client's review and approval

**8. Negotiate**

Negotiate from the client's point of view

**9. Billing and Collection**

Understand client's administrative and accounting practices  
Establish appropriate invoicing and payment terms for services

**COMPENSATION OPTIONS, (How architect will be compensated)****Stipulated or Lump Sum**

Fixed amount related to a specific scope of service  
 Over half of 1999 compensation  
 (Fixed Fee: 37%; Fee plus Reimbursable: 15%)  
 Clients like: Know price up front  
 Large dollar amount up front may be difficult for client to accept  
 Can encourage efficiencies in Arch. office,...Also big losses  
 Most typical for commercial/industrial and institutional  
 For Arch.: Greatest potential of profit and loss of all methods  
 Appropriate: Project scope and quality are well defined

**Hourly billing rates and fee multipliers, (Cost plus)**

Time and expenses+profit, (quoted as either multiples or flat rates)  
 24% of 1999 compensation  
 (Hourly: 10%; Hourly with not to exceed: 14%)  
 Often includes an upset figure, (upper limit)  
 Multiples:  
     1) Multiple of DSE or DPE, (hourly x multiplier)  
     2) Hourly or daily billing rates (everything figured in)  
 Useful when there are many unknowns  
 Most typical for residential  
 Owners don't like open-ended nature  
 Owner only pays for what is requested  
 No incentive to arch. for efficient time use  
 For Architect: Guards against losses, limits profit, direct income/work relation

**Cost plus fixed fee**

Hourly fee to cover costs, plus a fee for profit  
 Useful when a client doesn't want a completely open-ended fee arrangement  
 Limits architects' profit potential, but guards against losses

**Unit Costs**

Cost/building or s.f. or repetitive unit, (bed)  
 3% of 1999 compensation  
 Requires accurate data on costs of providing services

**Percentage of Construction Cost**

Ties compensation to construction cost, (rather than scope or services)  
 21% of 1999 compensation  
 Sometimes includes a "not to exceed" agreed sum  
 Easy for client to budget  
 Common method in institutional work  
 For architect: Income generally well related to work, (based on historical data)  
 Assumes cost of services is related to cost of construction  
 Allows const. market conditions to effect fee  
 Penalizes arch. who reduces const. cost, rewards for increasing const. cost  
 Level of compensation is unknown for a long time  
 Arch. has no incentive to keep construction cost down

Compensation methods are often combined, depending on services, within a project

		Stipulated or lump sum		Cost plus without upset		Cost plus with upset		Percent const. cost	Unit costs
<b>ARCHITECT'S PRACTICE MANAGE. CONSIDERATIONS</b>									
Encourages internal budgeting		■				■			■
Keeps records confidential		■							■
Fee adjusts automatically for scope changes							■		
Invoicing is easily understood		■							■
Allows for greatest profit but also carries greatest risk		■							■
Allows for base profit but protects against loss				■		■			
Allows for quickest start without negotiation							■		■
Permits the firm to guard against "scope creep"				■			■		
Needs greatest definition of project prior to start-up		■				■			
Does not penalize architect for project cost savings		■		■		■			■

		Stipulated or lump sum		Cost plus without upset		Cost plus with upset		Percent const. cost	Unit costs
<b>CLIENT NEEDS AND CHARACTERISTICS</b>									
Client requires quick start without complete project definition									
Client requires accounting detail									
Client must have total fee prior to starting project									
Client has numerous decision makers									
Client has extensive experience in the project type									
Client is oriented to lowest fee									
Client is developing prototype for many locations									

		Stipulated or lump sum		Cost plus without upset		Cost plus with upset		Percent const. cost		Unit costs
<b>PROJECT TYPE AND SERVICES</b>										
Well defined scope and schedule		■						■		
Prototype with scope/schedule not well defined				■						
Front-end work required for project definition				■						
Franchise restaurants, (etc.), where scope is clear		■						■		
Hotel, hospital, or other unit-based project		■								■
Facility surveys, int. design, and others on a piece basis										■
Site adaptation of a prototypical design		■		■						
Permitting services				■						
Construction contract administration services only				■						

# Setting Your Billable Rate

POSTED IN TIME TRACKING ([HTTPS://GETBRIC.COM/CATEGORY/TIME-TRACKING/](https://getbric.com/category/time-tracking/))



Calculating your billable rate is both important and challenging. As a professional service firm you sell an inventory of hours and skills. However you bill your clients — at the end of the day you sell time. You need to make sure that your inventory is properly priced.

Your goal: get the most return for your inventory of time and skills. Set your billable rate too high, you won't sell enough inventory. Too low, you won't generate the revenue you need to cover your costs, grow your business, and generate profit.

A good place to start is using the average range of \$100 to \$175 per hour for creative work. However, billable rates are different based on your market, specialization, and experience. Let's explore methods you can use to analyze your billable rates so they are "just right" — maximizing demand and profits.

There are several methods for finding your billable rate. We are going to look at three different methods that you can use to calculate your billable rate: billable rate survey, salary multiplies, and trial-and-error.

**Billable Rate Survey.** One of the best ways to quickly set your billable rates is to conduct a billable rate survey — interviewing people about how much they charge or how much they are willing to pay. Best of all, you can focus your interviews on agencies and clients that reflect your specialization, experience, and market.

However, this method presents some ethical challenges. Competitors don't want you to know their rates. In fact, most agencies have non-disclosure agreements with employees and clients that prevent anyone sharing their billable rates. Unless agency owners are willing to share billable rates, employees and clients can't help.

Also, asking prospective clients how much they have or would pay puts them in an awkward position. They have an obligation to get the best deal possible. Even if they provide you with a number, it probably will not represent their true threshold to pay for your services. Remember, a survey is only useful if you can trust the results.

So how do you ethically collect billable rates.

- **Third-party Surveys.** The best place to start is using a third-party Billable Rate Survey. For most industries a quick Google Search will produce great results. However, you might need to/want to purchase a third-party billable rate survey. For example, 4A's publishes a great annual billable rate survey ([http://www.aaaa.org/news/bulletins/pages/billrate15\\_06302015.aspx](http://www.aaaa.org/news/bulletins/pages/billrate15_06302015.aspx)) of the top advertising agencies in the United States. Even if you end up purchasing a billable rate survey it will be cheaper than conducting your own.

- *Join a Peer Group.* It is common for Industry Associations or business coaches to put together groups of business executives that are in same industry, similar size, and market; and don't compete against each other. This allow them to share experiences and knowledge without the threat of competition — including billable rates.
- *Neutral Parties.* If you do conduct a survey, you need to find people that are neutral. Survey people that don't compete with your agency, and they aren't planning to hire your agency. Yet, can provide relevant information about your market, experience level, and specialization. Without biases, they should be able to provide you with an accurate survey of billable rates.

**Salaries Multiples.** You can also set your billable rate by multiplying salaries divided by *employee utilization rate* (<http://getbric.com/calculating-employee-utilization/>). This is an effective method because it ties your billable rates to your clients' cost of hiring a full-time person. The multiple is your "reward" for providing your client with flexibility, managing the employee, and being able to recruit and train highly skilled workers.

Another benefit is stability. While salaries will vary based on market, multiples are fairly consistent. This means if your agency spans multiple markets, you can quickly adjust your billable rates based on adjustments to market salaries — adjustments for the cost of living and local competition.

According to AIGA the *average salary multiple for Graphic Designers* (<http://www.aiga.org/setting-rates-for-a-firm/>) is between 3.5 to 4.00. It is important to note that salary multiples will vary within your creative agency. Typically, agencies can charge higher salary multiples for more junior employees, and lower salary multiples for senior employees. Here are AIGA's recommendations:

- Principal: 2.50
- Senior designer: 3.00
- Designer: 3.50
- Production: 4.00
- Student Intern: 4.50
- Average for team: 3.50

To find billable rates using the salary multiplier use the following formula:

$$\text{Billable Rate} = (\text{Annual Salary} / \text{Target Billable Hours} (\text{http://getbric.com/calculating-employee-utilization/})) * \text{Industry Multiplier}$$

When using salary multiples it is important to be consistent in how you calculate annual salary and target billable hours.

**Trial and Error.** While you can use industry standards to set your billable rates, you will always need to refine them. Your creative agency is not the industry. Your agency is unique. There are two rule of thumbs that indicate that you need to adjust your billing rates — up or down.

*Billing Rate Too High.* Your billable rates are too high if you are constantly discounting your rates. As much as possible, your billable rates need to represent reality. Too many agency owners set their billable rates based on ego, and not what they can actually charge their clients. This leads a variance between billable time and chargeable time — what they actually invoice.

They might invest 20 billable hours at \$250 on a project, and only charge the client for 10 at \$150 per hour. They act as if the project is \$5,000, while it is only invoicing for \$1,500. However, they feel good about billing an above average rate, because they do above average work. Their clients agree they do great work. Unfortunately, no one is willing to pay their above average rates. Don't let your ego set your billable rates.

*Billing Rates Too Low.* If clients don't have to think about your proposals — they immediately accept — then you might need to increase your billing rates. When thinking about pricing economists use a tool called marginal value versus marginal price. This requires that the buyer has to think about if the value of the project is higher than the price. The price isn't low enough for the answer to be obvious.

There are some ethical issues with Trial and Error. Don't change your pricing often. This can be seen as manipulating prices, or price discrimination — changing prices depending on how much people are willing to pay. While, price discrimination is an economically sound practice — it allows companies to extract the maximum value from customers — it is societally frowned upon.

*In conclusion,* your billable rate is the first step to running a successful creative agency. It determines the types of client you will work with — volume and quality, the salaries you can offer employees, and whether or not you will have profits to reinvest in building the agency of your dreams. Spend some time every year analyzing your billable rates to make sure they are both competitive in the market, and can support your business/dreams.



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