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PRACTICE NOTE 08: BLENDED HOURLY RATE FEES FOR PRINCIPALS IN SMALL PRACTICES

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(This edition of Practice Note 8 replaces the first, August 2002 edition. It adds advice respecting young practices and overhead costs. It provides clarified terminology; analysis; and new sample calculations. It cautions regarding both profit margin and the use of hourly rates as a primary billing approach. It also contains occasional syntax and format adjustments. Substantive new or amended content is flagged by sidebar. Members are encouraged to review the entire document.)

a) Introduction

The current AIBC “Tariff of Fees for Architectural Services” (the Tariff) indicates (section 3.1) that one acceptable method of determining an architect’s professional compensation (or as a budget-check against fixed or percentage fees) is on a “time basis”. In section 3.4, that method and its application are explored in some depth. Amongst other things, the Tariff establishes recommended time-based fees for both architect-principals (at three levels of service: general, special, and expert) and an architectural firm’s staff. Members are encouraged to review the Tariff as well as Bulletins 51 and 52 (which are concerned with the Tariff’s highlights, including features having to do with hourly or “per diem” rates) and Bylaw 34.16, which requires (as a matter of an architect’s or an architectural firm’s ethical conduct) that services be provided in return for compensation in substantial accord with the Tariff.

The Tariff’s “principal” rates are not expected to apply to services which require less-than-principal skills and which could or should be delegated to staff and charged at lower rates, notwithstanding their occasionally being performed by principals.

Architect-principals who themselves nonetheless provide services at various skill levels (perhaps because they enjoy or prefer doing so; or because their firm’s human resources are limited and therefore certain tasks cannot be delegated to staff) may use corresponding variable hourly rates when billing for their time or — as cited under section 3.4 of the Tariff — a single “blended” rate.

(b) Background

The Tariff does not explicitly describe how a “blended” rate might be calculated; nor does the Tariff distinguish between architectural firms of different size or style of business operation. The latter is intentional: “principal” rates given and approved by AIBC Council are not cost-based but, rather, value-driven for principal-level services.

Nonetheless, the AIBC is well aware that (especially, but not only) in smaller architectural firms an architect-principal may be performing a variety of tasks that could otherwise be assigned to technical, administrative, or non-principal professional staff. Practice types include sole proprietorships, partnerships, and corporations, at times with limited staff support. In a typical working day, an architect-principal may act as (e.g.) senior design partner, drafter, and office administrator. In these circumstances, it may be appropriate to consider the establishment of billable hourly rates in a manner different from the particular rates set out in the Tariff as recommended for “**general principal-level**” services. Accordingly, two approaches are put forward for members’ interest and use.

(c) **Approach Options**

The recommended approach is to invoice different levels of services performed by the same architect-principal at a range of different hourly rates, to reflect the precise nature of the tasks, although this may not always be ideal in terms of administrative effort, billing simplicity and client comprehension. The formula outlined in the Tariff can be applied to a monthly staff-salary equivalent that is appropriate to each task, using 0.023 times the monthly salary to determine a specific billable hourly rate. Thus at times the architect-principal would be charged out at a rate appropriate to a drafter, and at other times, at the principal-level rates recommended in the Tariff.

An alternate approach is to establish a “blended” or “average” billable rate that reflects all overhead costs; the required gross salary; and a reasonable profit. (Note: “special” and “expert” principal services provide particularly enhanced value and may attract greater risk. Accordingly, they are outside the scope of a general blended rate and should be charged at levels consistent with the Tariff’s recommended rates as per Bulletin 51.)

While a number of ways to calculate the “blended” rate may be suggested, an appropriate formula would read:

$$\text{Hourly rate} = \frac{\text{required gross salary} + \text{overhead costs} + \text{profit}}{\text{billable hours}}; \text{ wherein:}$$

- “required gross salary” is the minimum gross salary appropriate and acceptable for the architect-principal, as explained in section (d);
- “overhead costs” include all costs truly associated with operating the practice, which are not directly recoverable as reimbursable expenses, based on the financial records of the practice;
- “profit” represents a reasonable expectation by the practice of surplus in fee billings compared to required salary + overhead costs; and
- “billable hours” is the recoverable portion of the actual hours worked by the architect-principal, based on the historical data of the practice or (especially for a new or young practice) upon projections based on comparable data from colleague firms; and/or diligently derived business expectations based on research and expert advice.

(d) **Explanations**

1. Required Gross Salary

To establish an accurate “blended” rate, the architect-principal must first establish the expected minimum gross salary for the year, which recognizes the education and experience of the architect-principal, and which is commensurate with the responsibilities and risks associated with professional practice.

2. Overhead Costs

To establish an accurate “blended” rate, a true assessment of overhead costs is necessary. Overhead includes (but is not limited to) such items as the following costs when not chargeable as reimbursable expenses:

- office space (rent, or value if part of residence);
- property taxes (including applicable portion of residence taxes);
- utilities (including applicable portion of residence utilities);
- leasing of equipment (or capitalized purchase cost);
- drawing materials;
- telephone and fax;
- computing and electronic communication costs;
- printing and copying;
- premiums for Professional Liability Insurance coverage;
- postage and courier services;
- insurance on office and equipment;
- typing and clerical services;
- accounting and bookkeeping services;
- financing;
- travel and vehicle;
- annual licence fee to AIBC and other professional or industry organizations;
- annual certificate of practice fee to AIBC;
- business licence fee and taxes;
- advertising and promotion;
- allowable entertainment;
- return on investment (usually the interest that could be earned if funds reinvested in the practice had been invested elsewhere);
- corporate taxes, where applicable; and
- health and other insurance premiums (may be business or personal expenses).

Until sufficient financial records are available, the architect-principal must realistically project the true cost of each of these items and/or obtain comparative figures from like practices, to ensure that the “blended” rate is as accurate as is feasible.

3. Billable Hours

Some sources would suggest that there are potentially 1950 “billable hours” in the work year (37.5 hours per week x 52 weeks). Others would suggest that they personally work in excess of that number (say, 44 hours) and that all of those hours are “billable”. Still others would

arrive at a lower total, reflecting a shorter work week, or vacation and holiday time. 1624 hours is a figure often used in calculating the hourly rate for office staff. Experience indicates that none of these assessments is necessarily applicable to the architect-principal in a small practice. The definition and true assessment of “billable hours” is a crucial step in developing an appropriate “blended” rate.

The architect-principal must be aware that there are many essential but non-billable hours in the normal work year. Non-billable hours often include time spent performing the following functions:

- marketing and promotion, business development;
- general office management functions not billable to any one specific project;
- volunteer efforts on behalf of the profession or community;
- clerical functions where not billable to any specific project (e.g. maintenance of product files); and
- professional development/ continuing education.

These non-recoverable hours may be presented as part of one “normal work week” (e.g. 17 of the 44 hours actually worked by one architect-principal) or may represent time invested in excess of another “normal work week” (e.g. 10 hours in addition to a usual 37.5-hour week).

The architect-principal must make a reasonably accurate estimate of the hours which will be worked and for which fee income will be received in each year, in order to arrive at an effective “blended” rate. It is most appropriate to base this assessment on actual financial records. Where none are available, it may be appropriate to estimate and plan that a percentage of actual work time will be devoted to non-billable activities.

Experience indicates that approximately 40% of an architect-principal’s time may be spent performing non-billable functions. Assuming a 44-hour regular work week, and that the architect-principal arranges time off for vacation and statutory holidays, the following analysis can determine a reasonable estimate of billable hours (1214) for the year.

Total annual hours:	44 hrs/week x 52 weeks =	2,288.00 hrs
Less:		
3 weeks vacation	44 hrs/week x 3 weeks =	-132.00 hrs
Statutory holidays	9 days x 8.8 hrs/day =	-79.20 hrs
Sick time	6 days x 8.8 hrs/day =	<u>-52.80 hrs</u>
Annual work hours:		2,024.00 hrs
Less non-billable hours:	0.40 x 2024 =	<u>-809.60 hrs</u>
Annual Billable Hours:		1,214.40 hrs

While larger firms can get as high as 75-80% billable time for some architect-principals, there will be managing architect-principals supporting these efforts at (say) only 50% billable time. Given the demographics of firms in the province, the 60% used in the table is a fair reflection of the majority of smaller practices and leaves room for improvement.

While 37.5 hours per week is the industry standard for staff, the 44 hours per week used for calculation purposes for architect-principals is a general reflection of the time difference frequently invested between employees and owners.

4. Profit

As the required gross salary is defined as the salary which represents the education and experience of the architect-principal while being commensurate with the responsibilities and risks involved in professional practice, there must be an allowance for profit in order to sustain the practice and make it financially viable in comparison to being an employee with no risks, as well as to maintain that required salary when fee income drops below anticipated levels, and to provide for retirement. Again, this is best derived from historical data and/or diligent research, expectations and expert advice.

(e) Sample Calculation

It is useful to apply some hypothetical numbers to section (c)'s formula. In the example, it is assumed that the required salary is \$140,000 and that the billable hours are 1,214.40 (as tabulated in section d.3). It is also assumed that a true estimate of the overhead costs is \$50,000 annually, and that the profit expectation is approximately 20% of the \$190,000 in fee billings (salary plus overhead), in this case \$38,000. The formula thus would read:

$$\text{Hourly rate} = \frac{\$140,000 + \$50,000 + \$38,000}{1,214.40 \text{ hours}} = \$188.00 \text{ per hour (rounded off)}$$

Thus, if the architect-principal completes the anticipated projects and receives fee income for 1,214.40 hours at the “blended” rate of \$188.00 the minimum salary of \$140,000 will be received; financial commitments related to the practice will be met; the balance of work time will be available to manage and promote the practice; and the architect-principal will have realized an additional profit to re-invest in the practice, to provide a “cushion” for slow periods, or to provide for retirement. If the architect-principal encounters such financial setbacks as bad debts, the “cushion” will help to absorb those without personal impact. If the 1,214.40 “billable hours” are, in fact, not billed, the “cushion” will also help to offset that shortfall. Of course, if through extra effort; greater fees on a fixed or percentage basis; or “special” or “expert” services, fee income is received for more than 1,214.40 hours at the “blended” rate, a higher profit than anticipated will be realized for the architect-principal.

(Note: in quick comparison, the Tariff's current general, principal-level rate is \$210.00 per hour.)

Finally, given that the architect-principal in the example realizes \$178,000 from the architect-principal's efforts (salary + profit) and realizing that the architect-principal **actually expended** 2,288.00 hours (including vacation, holiday and sick time for which the architect-principal received salary), note that the architect-principal's **personal** gross salary rate is actually \$77.80 per hour (\$178,000/2,288 hours) before taxes — which also needs to be factored into expectations.

(f) Caution

Each architect-principal should establish figures to be used in the formula based on their own situation and needs, personally and in practice. It should also be kept in mind that even though you may be performing non-principal activities you may be performing these more efficiently than staff of lesser experience, skill, effectiveness and decision-making responsibility, and so might readily bill your time at a higher rate. Accounting advice should be obtained.

Finally, it is noted that the AIBC does not recommend any particular or minimum profit margin and cautions against inappropriate use of hourly rates as a primary billing approach.

The AIBC is monitoring the Tariff's implementation. Suggestions and feedback are welcome and should be directed to the Director of Professional Practice.

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