



# Financial Management: Beyond Intuition

## Part One: The Basics

by Rena M. Klein, FAIA

### Do you **KNOW** if your firm is profitable?

As a financial management tool, intuition has its limits. While most small firm owners have a good sense of what's happening financially at their firms, operational indicators such as cash flow shortages or mounting receivables don't tell the whole story. Strategic decisions, such as when to hire or move from home to an outside office, require understanding of financial trends within your firm and ability to create financial forecasts, even in an unpredictable economic environment.

Financial management involves tracking key financial indicators pertinent to firm financial health and using the information to forecast likely future performance. Without some reasonable expectations of future revenue and expenses, it is difficult to plan and make basic business decisions. Understanding financial indicators helps you see what has just happened and what might realistically be expected to happen in the future.

#### Time Sheet Discipline

Steve L. Wintner, author of *Financial Management for Design Professionals* (2006), uses the term, "time sheet discipline" to emphasize the importance and, to some extent, the challenge of tracking time in professional service firms. After all, time spent working on projects is all that we have to sell as design professionals. Of course, we are selling our knowledge, creativity, and experience as well, which ultimately determine how valuable we are to our clients. But tracking time actually spent on projects, and on non-project activity, is how we can measure our

tangible performance in relation to the market value of our services.

Time tracking begins with having a system to record time and a way to collate the records into useful information. Both have been automated through the use of desktop software and mobile apps, and there are plenty of cloud-based low-cost solutions available on the web. It merely takes a commitment to keep accurate records of your time and a discipline to carry out that commitment throughout your firm.

Tracking hours is important in many ways to the operation of a firm. Figure 1 shows all the aspects of firm management that are touched by time tracking. These include payroll, invoicing, project tracking in relation to project budgets, and collection of data for key financial indicators and for future proposals and expense budgets.

As indicated in Figure 1, it is important that the time recorded is separated into direct hours and indirect hours. Direct hours are defined as hours spent working on a project under contract; indirect hours are all others, including time spent on marketing, interviewing with potential clients, and doing all other types of firm management work. As we know, not all indirect hours will turn out to be billable, but they should be recorded as direct hours nevertheless,

to provide an accurate record of what it actually took to do projects.

#### Key Financial Indicators

Key financial indicators are a subset of key performance indicators (KPIs) that can be tracked for many different aspects of a firm's operations. For example, KPIs for marketing might include the "hit-rate," a metric that tracks the number of jobs won relative to number of proposals sent out. For financial performance, there are a few metrics that are critical to quickly understanding the financial health of the firm. When viewed over time, these indicators can reveal the overall effectiveness of the firm's project acquisition and delivery processes.

Most of the financial indicators discussed here are ratios that measure performance in

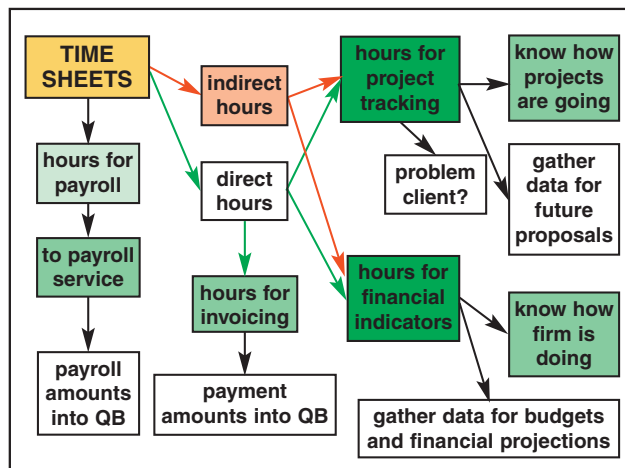


Figure 1: The importance of "Time Sheet Discipline"

relation to the cost of direct labor (salary, wages, or draws). This is the cost of the time put into working on projects. Mathematically this means that the metrics are ratios with direct labor expense as the denominator. Here are three important ratios to watch:

- **Overhead Ratio:** total indirect expense ÷ direct labor expense

Total indirect expense (aka: overhead) = indirect labor + payroll burden + general and administrative expenses. Payroll burden is the total of payroll related expenses, such as payroll taxes, health care, and retirement benefits. General and administrative expenses are all other expenses, such as rent and supplies.

Overhead rate answers the question: for every dollar spent on direct labor, how many dollars do I need to earn to cover the firm's overhead? Industry benchmark for overhead rate is \$1.50 – \$1.80, but it can vary significantly depending on firm location.

- **Break-Even Ratio:** [total indirect expense ÷ direct labor expense] + [direct labor expense ÷ direct labor expense] or simply, overhead rate + 1.

Break-even rate answers the question: for every dollar spent on direct labor, how many dollars do I need to earn to break-even – that is, cover both overhead and direct labor expense? Industry benchmark for break-even rate is \$2.50 – \$2.80.

- **Multiplier Achieved:** net operating revenue ÷ direct labor expense. Net operating revenue (NOR) is gross revenue (revenue from all sources) minus direct expenses, such as outside consultants and other reimbursable expenses. Direct expenses are expenses that would not exist if there were not projects. NOR is the amount of money available to actually run the firm and do the work of delivering projects.

Multiplier achieved answers the question: for every dollar spent on direct labor, how many dollars did I earn in net revenue? Industry benchmark for multiplier achieved is greater than \$3.00.

Once you have determined these ratios, it is possible to quickly determine whether the firm is making a profit. You can do this for any time period and as often as you like, as long as time sheets are up to date and direct labor expense is separated from indirect labor expense.

- **Profit Margin:** multiplier achieved minus break-even rate if the multiplier achieved is greater than the break-even rate, the firm is making a profit. If not, the opposite is true. It is a simple as that.

*Example:*

*Break-even ratio: 2.80*  
*Multiplier achieved: 3.50*  
*Profit Margin: .70*

If you multiply the profit margin times the direct labor expense, it will give you an estimate of the dollar amount of the profit (or loss) for the period of time you are examining.

*Example:*

*Profit margin: .70*  
*Direct labor expense: \$400,000*  
*Profit forecast: \$400,000 times .70 = \$280,000*

You can use these ratios to help you forecast financial performance looking forward. For example, if you know that your overhead is staying stable and that your staff is not changing, you can use the ratios from the previous year to predict likely near-term outcomes.

And, if you know, for example, that your direct labor expense is likely to be \$400,000, you can use your overhead ratio to determine likely overhead expense for the coming year: \$400,000 times 1.8 = \$720,000.

Then, the total revenue that you would need to break-even would be overhead expense plus direct labor: \$400,000 + \$720,000 = \$1,120,000.

This can also be figured by multiplying the break-even ratio by the direct labor expense: \$400,000 times 2.8 = \$1,120,000.

To accomplish a 20% profit over what is needed to break-even, divide net operating revenue forecast by the complement of 20% is .80. Therefore the amount of net operating revenue needed to break-even plus 20% profit is: \$1,120,000 ÷ .80 = \$1,400,000.

By doing these simple calculations, you can get a sense of what is needed in terms of project acquisition in the coming year to support your firm and be profitable.

- **Net Operating Revenue per Staff Member:** net operating revenue ÷ number of staff (Full Time Equivalency) This will provide a general notion of how much net operating

revenue would be needed to add another staff member.

## Trends Over Time

Tracking NOR, direct labor, indirect expenses, and profit/loss over time can give you an indication of the effectiveness of your production processes. It's not hard to generate a chart of your firm's past performance, looking simply at revenue, expenses, and profit/loss, such as the one shown in Figure 2.

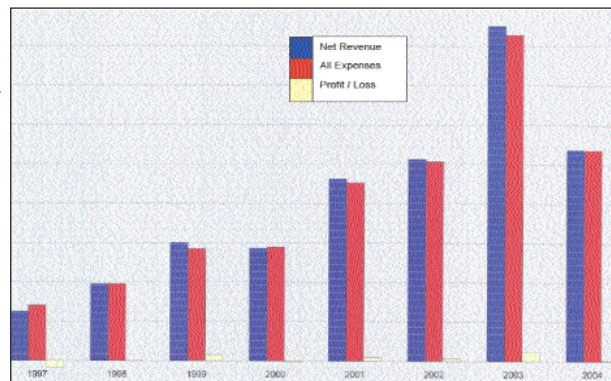


Figure 2: Stagnant profit/loss despite increasing net revenue

What you want to see, as an indication of firm financial health is the expenses staying fairly stable and profit/loss going up in parallel with revenue. However, if you see a pattern like the one in Figure 2, where profitability doesn't improve no matter how much work is completed, it is an indication that productivity is poor and work processes are likely inefficient. In this situation, best practice would be to look for bottlenecks in the production processes, poor communication, and unnecessary time spent "reinventing the wheel."

Financial management can provide a way to understand whether big picture professional goals are being accomplished, including those involving profitability and satisfactory compensation for both owners and staff. While profit is not the only "bottom line" that you may consider meaningful, it adds to the sense of satisfaction and success for most.

Look for Part 2 of this article in the next issue of Licensed Architect Magazine. Profit planning, revenue forecasting and annual budgets will be the topics covered. If you want to make a profit at your firm, and understand what the future might hold, this is information you need to know.

### 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.