Management Consulting Services
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Demystifying Financial Management Terminology – A Glossary of Terms

A big part of mastering any body of knowledge is an understanding of its vocabulary, jargon, or terminology. If you don't first understand the terminology of financial management, you'll have difficulty understanding its concepts. So mastering the terminology is something needs to be done as you begin the process.

accrual-basis accounting A method of accounting in which revenue is recognized in the period in which work is performed, and expenses are recognized in the period in which they occur, without regard to the timing of the exchange of cash. Accrual-basis accounting recognizes the obligations that parties have to one another—the fees owed to your firm by its clients for work performed, and the fees your firm owes to the firm's consultants or the payments owed to vendors—whether or not an invoice has been sent or received, and whether or not an invoice has been paid.

accounts payable The total dollar amount of invoices your firm has received from consultants and vendors and which the firm has not yet paid. Accounts payable are regarded as a Current Liability on the firm's Balance Sheet.

accounts receivable The total dollar amount of invoices your firm has submitted to clients and for which payment has not yet been received. Accounts receivable that have not been classified as uncollectable (see "bad debt") are regarded as a Current Asset on the firm's Balance Sheet.

aged accounts receivable Aged accounts receivable are unpaid project invoices previously sent to clients. The average time interval, in days, between the invoice date and the current date, for all outstanding, unpaid invoices represents the "aging" of these invoices. The lower the number of average days aged, the better your cash flow.

asset Cash, or any item of economic value that can easily be converted to cash.

bad debt Accounts receivable that the firm has concluded is uncollectable and is therefore "written off" as a miscellaneous expense on the firm's Profit/Loss Statement.

balance sheet A financial report that summarizes the assets, liabilities, and equity of a business enterprise on the date on which the report is generated.

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billing rate The dollar amount that your firm charges for an hour of direct labor, including overhead and profit.

break-even cost The dollar amount of the cost to your firm for the total number of hours of direct labor at the break-even rate.

break-even rate The dollar amount of the cost to your projects for an hour of direct labor (hourly salary rate times the overhead rate plus the hourly salary rate). Work performed at less than the break-even rate will obviously result in a loss.

budget A projection of future revenue and expenses for a specified time period. An annual budget is an essential tool of financial management for professional design firms, while a project fee budget is an essential tool for managing projects profitably.

capital Cash or goods (but most often cash) invested in a firm by its shareholders to support business operations. Every firm requires some reasonable investment of capital at the firm's inception, but additional capital can be invested at any time during the firm's existence.

capital expenditure A nonoperational expense for tangible assets having a useful life of more than twelve months that are intended to support business operations, such as computer equipment, office furniture, or telecommunications systems.

cash-basis accounting A method of accounting in which income is recognized when payment is received and expenses are recognized when they are paid; in other words, when money is exchanged. Income taxes should only be calculated on a cash basis, because a firm should only choose to pay taxes on the money it has actually received.

cash flow The flow of money in and out of a business.

cash-flow report An accounting statement that shows the amount of cash generated and used by a business in a given period.

chart of accounts A complete list of all income/revenue and expenses to which all financial transactions can be charged or posted. The chart of accounts is the fundamental building block of every accounting system, and can be customized for every business.

credit This word has many different meanings depending on its context, but with respect to accounting and bookkeeping, it refers to a positive dollar amount entered into a ledger.

debit The opposite of a credit; a negative dollar amount entered into a ledger.

depreciation A noncash expense that reduces the value of a tangible asset (such as real property, vehicles, or equipment) over time as a result of wear and tear, age, or obsolescence.

direct expense Any nonreimbursable expense that can be attributed or charged directly to a project.

direct labor The cost of labor (hours) that can be attributed or charged directly to a project.

distributions The total dollar amount "distributed" to employees of the firm as performance bonuses, earned through each individual's contribution to the firm's net profit.

EBIDTA Earnings before interest, depreciation, tax, and amortization. Because most professional design firms have relatively few assets and only modest financing, EBIDTA is rarely used to analyze their performance. Other metrics such as net operating revenue (see later in this glossary) are more useful.

equity The value of stock or other security representing an ownership interest in the firm.

exempt employee An employee who is exempt from the minimum wage and overtime pay requirements of the U.S. Fair Labor Standards Act, by virtue of the employee's status as a bona fide executive, administrative (managerial), professional, or outside sales employee. (See "non-exempt employee," below.)

fee The amount of money that you and your client agree your firm will be paid for a defined scope of work.

firm leader The chief executive officer (CEO) of a professional design firm, or whoever is the single individual with primary responsibility for the financial stewardship of the firm.

firm principal A member of the firm's senior leadership or management team.

fixed expense A recurring, periodic expense that does not change from one period to another, and does not fluctuate in relation to business activity for the year (e.g., rent, insurance, auto lease payments).

forecast An adjusted projection of future revenue and expenses for a specified period (such as an annual budget) in order to account for a major unanticipated event that could make a comparison between the original budget and actual financial activity difficult.

GAAP (Generally accepted accounting principles.) Standard accounting principles that primarily apply to a publicly traded company. You should seek financial and legal advice beyond this description.

income Any money received by your firm, for work performed or as return on investments. The definitions of *income* and *revenue* have distinct, nonsynonymous meanings. We use *income* to refer to the receipt of money. *Revenue* is earned when work is performed; usually well in advance of the receipt of any money.

income statement Another term for the cash-basis *Profit/Loss Statement* (see below).

indirect expense A business expense that cannot be attributed or charged directly to a project.

indirect labor The cost of labor (time) that cannot be attributed or charged directly to a project.

liability An obligation to pay a debt; something you owe to someone else.

liquidity A measure of a firm's ability to readily and quickly convert assets, excluding fixed assets, to cash. Liquidity can be expressed numerically as the ratio between easily converted current assets (such as cash, accounts receivable, work-in-progress) and total current liabilities, and is often referred to as the "quick ratio," or "acid test".

leverage An indication of whether a company is managing its debt appropriately. Leverage is defined numerically as the ratio between total liabilities and total equity. It is often referred to as the debt-to-equity ratio. The lower the ratio, the better. Total liabilities should not exceed total equity by more than 35 percent.

net multiplier The ratio of net operating revenue to total direct labor. It tells you how many dollars of revenue your firm is generating for every dollar spent on direct labor. If the net multiplier is less than the break-even rate, the firm is operating at a loss.

net operating revenue The sum of total fees billed and total reimbursable expenses billed, minus the cost to the firm of outside project consultants and all project-related expenses. NOR is the baseline value on the accrual-basis P/L statement—the "100 percent" against which all other P/L Statement values are compared.

net revenue per employee The ratio of net operating revenue to the number of employees. It's a useful gauge for checking whether the NOR you're projecting for the coming year is realistic and sufficient to support the budgeted cost of operations.

non-exempt employee An employee who is *not* exempt from the minimum wage and overtime pay requirements of the U.S. Fair Labor Standards Act.[1] (See "exempt employee," above.)

overhead cost The dollar amount of the cost to your firm for an hour of salary based on the current, calculated overhead rate.

overhead rate The ratio of a firm's total indirect expense to the total direct labor expense. You need to know your overhead rate to establish break-even and billing rates, which in turn allows you to develop appropriate, profitable fees for your services.

profit The dollar amount remaining after salaries, consultants, and expenses are paid. On the accrual-basis P/L Statement, *gross profit* is the dollar amount remaining after all operational expenses are paid, but before other (nonoperational) revenue and expenses (things such as interest or miscellaneous revenue, or the expense of writing off bad debt), are taken into account. *Net profit* is the dollar amount remaining after "miscellaneous revenue and expenses" are taken into account, but before taxes and distributions (employee bonuses and shareholder dividends) are paid. On the cash-basis P/L Statement (generated only to determine tax liability), profit is calculated by measuring *income* (actual money received) versus expenses. (See *accrual-basis accounting* and *cash-basis accounting,* above.)

Profit/Loss (P/L) Statement A financial report that summarizes revenue and expenses and shows the profit or loss of a business enterprise for a specified accounting period. There are two types of P/L Statements: cash-basis and accrual-basis. (See *accrual-basis accounting* and *cash-basis accounting,* above)

profit to earnings (P/E) ratio The ratio of net profit (before distributions and taxes) to net operating revenue. The P/E ratio indicates your firm's effectiveness in completing projects profitably. The higher the ratio, the more profitable the firm.

profitability The ability or capacity of a firm to earn a profit. While it may seem obvious, the best way to ensure profitability is for your firm to always earn more than it spends, since every dollar of expense is one less dollar of profit.

project-related expense Any expense, whether reimbursable or direct, that can be *attributed to* or *charged* directly to a project.

reimbursable expense A *project-related expense* that is not included in the fixed fee and therefore can be invoiced to the client separately, in addition to the contract fee.

retained earnings The portion of a company's after-tax profit that is not paid out as shareholder distributions but rather is *retained* for capital investment or to pay previously-incurred debt. Retained earnings represent the cumulative profit or loss of the firm since its inception.

return on equity A measure of what the stockholders of a company are getting back for their investment. It should be at least equal to, and preferably higher than, a firm's targeted profit. Return on equity is expressed numerically as the ratio between net operating revenue less total expenses, divided by total equity. Often referred to as shareholder's equity.

revenue The value of assets that accrue to a professional design firm from the performance of professional services. Revenue is earned when the service is performed, and is distinguished from income, which is the actual receipt of money for work performed. Most design firms calculate their revenue on a modified accrual-basis for 'fees billed', once earned.

shareholder distributions Not to be confused with "distribution" (employee bonuses), above. "Shareholder distributions" is money distributed to the firm's shareholders (owners) from the firm's profits, usually according to a defined formula. In many professional design firms, the shareholders may also be employees, but unlike "distributions," "shareholder distributions" are unrelated to individual job performance and are not bonuses.

shareholder An individual with an equity (ownership) interest in a firm.

solvency A measure of a firm's ability to meet its current debt. Solvency can be expressed numerically as the ratio between a firm's total current assets and total current liabilities, often referred to as the 'current ratio'. A ratio of 1.5:1 or better is desirable.

variable expense A business expense that fluctuates in relation to business activity, such as consumable office supplies, equipment repairs, banking charges, or business travel.

utilization rate The ratio of the hours worked on projects (direct labor) to total hours worked by all members of the firm (total labor). Individual utilization rates also can be calculated for every member of the firm. The utilization rate is a measure of overall efficiency. The utilization rate is *not* a measure of productivity and is not an appropriate metric for evaluating the overall financial performance of professional design firms or the performance of individual employees.

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