Financial Management: 10 Key Performance Indicators

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SUMMARY

Steve Wintner, AIA, outlines 10 financial performance indicators that an owner must understand to properly manage a firm's finances.

UNDERSTANDING THE NUMBERS

Understanding these 10 key financial performance indicators for professional service firms may help you to better manage your firm's finances and make better business decisions.

TEN PERFORMANCE INDICATORS

Utilization rate. The utilization rate is the percentage of hours spent on billable projects vs. the total number of hours worked. It is *not* a measure of productivity. A reasonable goal for the entire staff would be a utilization rate of 60 percent to 65 percent, and for professional and technical staff—including principals—a reasonable goal would be 75 percent to 85 percent.

Overhead rate. The overhead rate is the cost of non-project-related expenditures (indirect expenses, including indirect labor) expressed as a percentage of total direct labor. It's perhaps the most critical of all the performance factors. If it is unknown or calculated incorrectly, it is impossible to accurately determine the firm's profitability. The lower the overhead rate, the higher the profit margin. A target of 150 percent to 175 percent of total direct labor (1.5 to 1.75 x total direct labor) would be acceptable. Managing indirect expenses will reduce the overhead rate. A rate that exceeds 1.75 should be cause for concern and immediate action.

Break-even rate. Each employee of the firm has his or her own break-even cost, which represents the actual cost of each person's employment. It's equal to the overhead rate plus each person's hourly salary, represented by the unit of 1.0. If a firm has an overhead rate of 1.5 (150 percent), then the break-even rate for each employee is 2.5 x hourly salary (1.0 + 1.5 = 2.5). For an hourly salary of $10, the break-even cost would be $25 per hour. To develop an hourly billing rate for each employee, divide the break-even cost by the complement of a desired profit margin ($25 ÷ 0.8) = $31.25 (for a profit margin of 20 percent).

Net multiplier. The net multiplier represents the actual revenue generated by the firm, expressed as a percentage (or multiple) of total direct labor. If the net multiplier is greater than the break-even rate, the firm is earning a profit. If it is less than the break-even rate, the firm is losing money.

Aged accounts receivable. The average age of a firm's accounts receivable can be calculated. The formula: average annual (last 12 months) dollar amount of unpaid invoices ÷ (net operating revenue ÷ 365 days). Firms should strive to collect all outstanding invoices within 60 days of the invoice date; anything exceeding 90 days should be cause for concern and follow-up.

Profit-to-earnings ratio. The profit-to-earnings ratio is determined by dividing the profit (before + distributions and taxes) by the net operating revenue. It indicates a firm's effectiveness in completing projects profitably.

Net revenue per employee. The net revenue per employee is calculated by dividing the annual net operating revenue by the number of employees. It is useful in forecasting a realistic range for future annual net operating revenue.

Cash flow. Cash flow is a measure of how much money the firm actually has on hand at any given time to pay accounts payable: employee salaries, taxes, insurance premiums, reimbursable expenses, subconsultants' fees, and expenses. While a firm may appear to be profitable on paper, cash flow can be a serious challenge for professional service firms and can adversely affect the ability of a firm to meet its financial obligations to employees, vendors, and consultants in a timely manner.

A monthly cash flow report and 12-month cash flow projection can help a firm plan ahead to smooth out the swings in cash flow by accelerating collections, requesting an initial payment prior to starting a project, and carefully planning purchases of equipment and supplies. A line of credit may also be helpful (and necessary) but should only be used sparingly, as the cost of interest to finance operations may cut deeply into profits. Habitual dependence on a line of credit may also mask serious financial management problems and create a false sense of security and profitability.

Proposals pending. Proposals pending is a factor made up of two components: (a) prospects, which are proposals that the firm has a 50 percent or better chance of winning, and (b) suspects, which are proposals that the firm has less than a 50 percent chance of winning. These dollar amounts should be compared to the firm's budgeted annual net operating revenue. The total dollar amount of prospects and suspects should be 2.5 to 3 times net operating revenue, with prospects at least equal to net operating revenue and suspects 1.5 to 2 times net operating revenue. Maintaining these numbers is the responsibility of the marketing personnel.

Backlog volume. The backlog volume is the unbilled dollar value of a firm's current fee contracts. Because monthly invoices continually reduce the firm's backlog volume, it is essential to continually replace invoiced fees with newly contracted fees. A desirable target for backlog volume is equal to, or greater than, the firm's budgeted annual net operating revenue.

ABOUT THE CONTRIBUTOR

Steve L. Wintner, AIA, is the founder and principal of Management Consulting Services, a Houston-based firm specializing in professional design firm management. A licensed architect since 1968, Wintner served as a past chair (1989) of the AIA Practice Management Committee; vice president and director of operations for several internationally prominent architecture firms; managing principal of his own architecture firm; and coauthor of *Financial Management for Design Professionals: The Path to Profitability*.

RESOURCES

More Best Practices

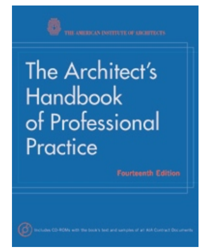
The following AIA Best Practices provide additional information related to this topic:

08.03.04 Starting a Firm: Basic Financial Principles

08.01.02 Starting a Firm: Essential Financial Vocabulary

For More Information on This Topic

See also "Financial Systems" and "Financial Planning," by Lowell Getz, CPA, and "Financial Health" and "Acquiring Capital," by Peter Piven, FAIA, *The Architect's Handbook of Professional Practice*, 13th edition, Chapter 8, pages 183, 194, 203, and 214, respectively.



See also the 14th edition of the *Handbook*, which can be ordered from the AIA Bookstore by calling 800-242-3837 (option 4) or by email at bookstore@aia.org.

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- Practice
- Financial management