A Fiscal Check-up For Construction Companies (Back to Table of Contents)

The construction market is on a rebound after years of difficult market conditions. Tough years have placed a financial strain on construction companies large and small. For some, slimmer returns will continue into the recovery. It depends on an organization's "come-back" ability. When a company has suffered poor-performance for a time during a downturn, it often experiences decreased equity, not just profitability and increases in borrowing to the extent that credit worthiness is threatened. Rushing back into a good market without a fiscal check-up can be a mistake. An organization needs to be properly postured to grow again after a stressful period because growth eats cash that can strain a company to the breaking point

The Manifestations of Distress

Cash Flow Problems: Most construction companies that get into serious cash flow problems do not see it coming. Financial stress during either downturn or growth periods needs to be addressed quickly. A simple check-up test may be in order. A company enduring any three of the items listed below is probably stressed. It may not be financial distress yet, but in the closely-held construction enterprise, any drop in performance erodes financial strength and increases the financial risk the company is at.

Disproportionate increases in overhead: Companies that are increasing in overhead often claim, "It's because we're growing." However, a further check indicates that last year they did $20 million with a certain overhead. This year overhead is up 30 percent, but volume is only up 20 percent. It can be worse when downsizing if sales are down 20% percent with little or no change in overhead.

Increase in turnover in personnel: Unexplained departure of people "in the know".

Late accounting information: When the accounting information does not come out on time it is often because the numbers are not adding up, and the preparers are looking for more data, or massaging the data.

Late financial information: Most of the information we get in our industry is a little later than we wish it was, but if it is later than usual, stress may be indicated.

Unexpected borrowing: All borrowing, whether for working capital equipment or expansion, should be predictable well in advance. Unexpected borrowing is an absolute indicator of financial distress.

Increase in internal disputes: Under-performance breeds discontentment.

Decrease in the quality of the work: During financial stress the work suffers, the stress shows.

Too many excuses. If more things are going wrong and fewer people can provide the reasons, performance is slipping.

Departures in the accounting staff: Of the hundreds of companies in jeopardy studied, more than 40 percent had the CFO or the second down in the accounting department leave within three years prior to failure. It is fair say that if the CFO leaves, there is a good chance that there is difficulty within the company.

Inadequate time to do anything well: Everything is done just to catch up. This does not mean that working six days or long hours are unusual. However, not having time to get bases covered because more time than usual is spent with our attorneys, outside accountant's or chasing money may mean there are problems.

Measuring the elements of construction company financial performance
There are means of quantitatively measuring the elements of our business: **Debt-to-equity should be a constant.** If we look back three years at our financial records and find that our debt-to-equity ratio is deteriorating, then performance may not be what it should be.

For example, let's look at a company doing $20 million a year with profits after tax of $500,000. If they do not take the profit out of the business equity goes up. To produce $20 million, they carry $2 million in secured equipment debt and $1 million in unsecured working capital. This hypothetical company has equity of four million and debt of three million. Then they grow to $22 or $23 million the next year, adding the million to equity. The company had $3 million in debt before, and equity of $4 million, which is a 3:4 ratio. But now they leave in another $500,000, increasing equity to $4.5 million. To hold the 3:4 ratio, they can safely increase debt by only $375,000. If debt increases any more than that in the following year, irrespective of growth, financial strength has weakened and financial risk increased.

Relationship of total assets to total liability. When the liabilities-to-asset ratios start to shift in under-performing companies, they shift to the negative. That is, the ratio of liabilities to assets is greater than when the company was performing well.

For example, your books and records show that you made $100,000 this year. Theoretically, you could write yourself a check for $100,000, however, the money may not be in cash, or available. But you take $50,000 out of the business. Within months, typically one quarter, liabilities will build up some. If the $50,000 was not available profit, then it will be immediately replaced with debt. Some say, "Well, I didn't borrow any money." Payables just went up $50,000. The balance between total liabilities and total assets is shifted which means the company is a little weaker financially.

Appropriate Reactions
If you are not satisfied with your organization's performance, action is necessary. Too many managers are content with marginal performance, particularly after difficult periods. You need to look at the orders of magnitude and start trying to differentiate between slipping a little and being in jeopardy of serious financial distress. If you are slipping a little, you can take some action. But if you are in jeopardy, you need to take drastic action. In the most severe case, you may even need to go into survival mode.

Construction business Basics
An understanding of the dynamics of the construction business is a prerequisite to taking corrective action to unsatisfactory trends. There are three functional areas to consider:
1. Marketing and sales - getting the work. In survival, we put this on the back burner.
2. Operations or production - doing the work. In survival this is all that matters.
3. Administration and accounting - measurement of performance. In survival, do not worry about this function because there is no need to invest in the measurement of non-performance.
To reverse unsatisfactory performance timing is critical so work on operations because it is the only area that can provide cash flow and hopefully profits. Profits for the closely held construction company are directly proportional to the attention paid to field operations.

Manage Volume
Understanding your organization's optimum volume is critical to success. When the market rebounds, too many companies take more work than they can handle, get stretched thin and actually make less money rather than more. An honest appraisal of an organization's optimum capacity and capabilities is necessary to determine how much work the company can effectively manage while maximizing profits. When existing, trusted and proven field supervision is fully employed a construction organization is at capacity. When more work requires untested people be moved up or new hires begin to run work an organization exceeds its capacity and undertakes some performance risk. Managing that risk is important to consistent performance so rate of growth becomes a factor.

Volume Management
The new concept of "volume management" suggest that management is responsible to control sales within pre-set, self-imposed guidelines based upon management's appraisal of optimum volume measured in dollars or number of projects. A company may grow by taking more projects of the same size or number of projects remains constant while project size increases or a combination. With more projects a company growing by 25% or 50 % in a year or two will have a quarter or half of its production in the hands of untested field management. If the projects are simply larger field management may find themselves a little over their head. Either way, it is not business as usual. There is additional performance risk compared to when all work is controlled by known and tested employees, which we all know is not risk free to begin with.

Measuring Performance Risk
It is difficult to quantify the performance risk resulting from untested field management so the risk control method becomes one of balance and risk assumption in proportion to one's ability to withstand the downside. The risk of under-performance is the loss of a portion of bid profit or the failure to exceed bid profit if the opportunity existed. The farther field management is stretched, the greater the risk of under-performance. Therefore risk goes up as volume increases. In my experience, up to 15% growth per year, excluding inflation, has modest or little risk. Growth over that rate increases exponentially to the extent that 50% growth in one year is considerable risk and 100% or more is severe risk. A company that doubles its size in one year is literally not the same company and its risk of failure is close to if not equal to that of a start-up organization.

Managed Sales
Many companies have the attitude that they can and will produce as much work as they can procure, but the true test is can it be built at a profit and at what risk. Few contractors are willing to walk away from additional work during a growth market, but if the question were: more work or more profit they might think about it twice. Growing the profitability and value of the company should be the primary goal and where value is concerned, risk must be considered. Risk increases as volume grows so the value conscious contractor should be anxious to analyze capacity and manage sales as a method of risk control.

Conclusion
The ultimate measure of performance is not what is earned but how the earnings are valued by the investors. The broad goal of every firm should be to maximize the wealth of the firm's

shareholders through achieving the highest possible value for the firm. A firm's increase in value, not just its profits, are the true measure of company's performance. Therefore, it is necessary to measure the risk that the firm's value is put at in the pursuit of profit in order to measure its overall financial performance.

There are serious drawbacks to profit maximization as the primary goal of a firm because a change in profit can also represent a change in risk which directly affects the value of the company. For example, a conservative firm that earned $100,000 in a year may be a less desirable investment if its earnings per share increased to $125,000 but the risk inherent in the operation increases substantially (reducing the firm's value). Managing financial risk and financial performance is the key to survival for the closely held company. Remaining in business relies more on long-range value issues than shorter range profit concerns. Profit planning relies almost entirely on assumptions about the future while the longer term approach of maximizing the value of the business relies very strongly on the control of risk and the measurement and protection of existing value.