Corporate Self-Analysis

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To begin any planning process and effectively decide the future of an organization, it is important to precisely establish the organization's present status, which requires a review of where the organization has been. For many contractors, a comprehensive analysis of the last three to five year history of their company is a good learning experience; and for some it may be a little surprising. Many business owners deal with the good years and bad years as they come along, but have not considered their organization's average performance over time. Many entrepreneurs provide very specific reasons or causes for their bad years; at the same time they consider all their good years as the norm. When plans made on this basis don't work out, it is often because too much optimism is built on the assumption good years are normal years and will repeat themselves, while bad years are an anomaly and unlikely to be repeated. This complicates measuring a company's current performance against its prior performance, a necessary element in corporate self-analyses.

It is necessary and difficult for contractors to measure their performance against industry norms. However, it is hard to measure "success" with all the meanings it can have in a closely held company, and even harder to evaluate how the competition is performing in comparison. Many contractors are working in an information vacuum. They complain that even in good times they're never sure their organization is performing at optimum levels. Some contractors state difficulty in defining and judging their own performance because they don't know the margins for similar contractors. With over a million separate contracting companies, the industry is spread out and fragmented with so many different specialized businesses that determining norms for an industry segment is a science in itself.

Measuring a construction company's performance includes an analysis of its financial performance. Particular attention should be focused on an organization's previous financial performances and changes in certain financial ratios to discover trends in the company's performance. An internal comparison of ratios over a five year period of a single company provides accurate information about how that company is performing against their own historical norms. After collecting information from hundreds of firms, the authors are convinced that more is gained by studying changes in financial ratios over a five year period than of year-to-year comparisons or against various compilations of industry "norms." To accurately determine industry norms, data collected should be averaged carefully and in some studies, it is advised to discard the extremes (high and low).

Corporate self-analysis does not require the entire planning group because the subject matter primarily concerns the owner(s). The authors consider corporate self-analysis as an essential part of the business planning process, and it can also be used effectively on its own when planning is not the issue. Every contractor should stop and take stock of where they stand periodically and analyze carefully how the organization is performing. High risks in the construction business can be substantially reduced by recognizing the strengths and weaknesses of an organization. Corporate self-analysis helps the contractor understand how to best capitalize on strengths while building defensive postures for weaknesses that may not be easily changed or improved. Corporate self-analysis allows organizations to

obtain an effective measure of annual performance against other years and determine if average profitability (performance) is improving or declining over time.

For the contractor deciding against engaging in a strategic business planning process, the authors recommend they consider preforming, at a minimum, a detailed corporate self-analyses. To be most effective, this activity may require input from someone outside the organization such as the company's independent accounting firm. This consists of a detailed financial analysis of the prior five years of financial statements which can be prepared in-house or by the company's independent accounting firm. The detailed evaluation of the financial analysis has given a lot of contractors peace of mind and many others the opportunity to make some necessary changes before it was too late. The following is a the step-by-step process on how to conduct a corporate self-analysis.

Managing the Corporate Self-Analysis Process

The first step to conduct a corporate self-analysis is the collecting and compiling of required financial data, shown in Table 5.1. This information is collected directly from the company's annual financial statements and recorded on an Excel spread sheet or equivalent. It is recommended to take the most recent annual statement and the previous four years since then. A three-year study is the minimum length one can learn from and any duration longer than five years does not appear to enhance the evaluation. The ratios are simply calculated from the formulas in the sample corporate self-analysis calculation sheet shown in Figure 5.1. Both the data collection and the calculations of the ratios can be assigned to someone in the accounting department or can be carried out by executive staff if confidentiality is desired for any reason. It should be noted that a major concern throughout this process is transcription errors, therefore, it is prudent to have a second person check the data. Some people find the information easier to understand if the data is presented on a chart depicting particular categories of interest. As time progresses, the financial analysis can be easily updated and used in subsequent years.

The owner(s) of the company decide who should be involved in the financial corporate self-analysis process. Some prefer to include only owners or partners, others include a few top managers, and some include their entire organization's planning group. Complete financial disclosure can be avoided if ratios are only used which provide relative performance.

Exploring the data will determine if any non-operational events occurred, leading to "spikes" in certain years, financial maneuvering prior years for tax purposes, or extraordinary bonuses that may require adjustments. Since the study is an attempt to analyze the companies' organizational performance while excluding non-operations activities, non-operational financial maneuvers should be adjusted out, as this type of information is the exclusive concern of company owners.

A review of two, three, and four-year average profitability is informative of progress and direction. Growth or diminishing total sales are directly conveyed from the spreadsheet and the averages may be of interest to the planners. Similarly, profits or loss show up clearly on the spreadsheet, along with general and administrative expenses. Immediately, it would become obvious if General and

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Administrative (G&A) expenses were growing disproportionally to sales, an issue planners would look at closely and may discover, in some cases, gross profit rising while net profit is decreasing.

From a real-world case with the authors, planners dissected a construction enterprise's G&A expenses for the past several years and concluded none of the new single items grew; instead, they found nearly all of the overhead items were going up. Some discussion occurred about inflation causing it, but the planners quickly agreed they were in charge of the business' destiny and, if the trend continued, they would eventually lose money while earning a good gross margin on their work. From this exercise alone they took action and, in one year, the company's overhead was back to the five-year average as a ratio of sales. In the second year, the sales improved a little resulting in a general and administrative ratio decreased to the prior four-year level. Non-financial managers can learn from this effort.

Contractors can enjoy significant benefits immediately following the exercise. For example, in one the authors discovered net profit was improving over time while G&A was decreasing, indicating a deterioration in gross profit margin. This is far more serious than the previous real-world case shared because it indicates a problem in operations/production, which is much harder to rectify than controlling general and administrative expenses. After a serious discussion with the principals they realized a number of new inexperienced field superintendents were promoted during the company's rapid growth years and the group was not producing the work as profitably as the more experienced superintendents. The principals concluded further growth would be a mistake and continued losses would put their entire operation in jeopardy. They cut back volume by taking no new work for six months and concentrate all their efforts on an intensive training program for new superintendents. They decided sales should not grow until the organization returned to the average gross profits value they had in the four out of five previous years. Their goal was achieved in nine months and in the second year they earned a one and a half percent increase over their five year average gross profit percentage.

In the previous case study, the owners of the construction company were unaware of the problem until the losing year transpired. They made the common error of thinking the slippage in net profit was the price to pay for growth. The owners fell into the trap of believing it was something they called "growing pains" until they realized that a strategic business plan was necessary to assure their future success. The financial corporate self-analysis allowed immediate discovery of the problem which focused the company's energy on the solution.

After the spreadsheet is compiled and the graphs are prepared the key people should plan a meeting to analyze the results. As many questions will arise the team should have quick access to the company's records and key individuals for answers.

Financial performance is the starting point. A number of other areas should be on the agenda and discussed in detail. These include:

- The company's current market position.
- What does available work look like for the next year or two?

- How does the company compare with its competition and what are its competitive advantages and disadvantages?
- Are current operations/production optimum and to your satisfaction?
- Is the structure of the organization suitable to its current workload and will it remain the same or change if you plan to grow?
- Is there a clear chain of command and do all the people in the organization understand the reporting chain and their responsibilities?

The questions may seem fairly simple, but it is key that owners take the time to review these issues simultaneously and discuss the answers to these questions in light of the five-year financial performance analysis. What happens often in a closely held business is that the owners evaluate their business on a continuous basis and because most entrepreneurs are pretty optimistic it tends to shade performance evaluation. Optimism can cause a business owner to rate their performance on the good years which may not provide a realistic picture of what the past has been or what the future may hold.

Final Thoughts

A properly carried out corporate self-analysis forces a realistic evaluation of the facts related to the organization's performance. The exercise is most effective in highlighting strengths to be exploited and in bringing to the surface weaknesses to be dealt with that natural entrepreneurial optimism may cloud. It is also effective in surfacing personality issues among managers that can dramatically affect an organization's performance and can be left to fester for years because in many closely held businesses there is no ready forum to address them.

As a free-standing activity, a corporate self-analysis is a great tool to maximize the benefits of a subsequent business planning effort. After studying and discussing the financial analysis and answering the internal and external questions, the business owners should review their personal and corporate goals with each other. There is plenty to learn about an organization from what is unknown, unquestioned, unsaid or buried, along with the probability of unstated, unsatisfied personal or professional goals among business owners which creates stress that is better channeled into motivational forces.

In the years to come, the construction industry will continue to become more complex, amplifying risk. To profit contractors will need to work more efficiently, however, they will not know accurately or timely if that is happening without greater attention to, and respect for, the accounting functions of their businesses and the people who carry them out. In the next chapter, the authors will share methods to measure financial risk and provide tools to identify indicators of potential financial distress