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HANK HARRIS

Financial Controls for Value Creation

This article contains an excerpt from Hank Harris's forthcoming book, "Creating Value in an Engineering Construction Business," a comprehensive guide to creating and perpetuating value in a design or construction firm. In Chapter 6, Harris details the importance of financial controls as indicators of firm health and tools for long-term value creation. Excerpted here are selections from his conversation with FMI principal Ken Roper. "Creating Value in an Engineering Construction Business" will be published in 2015.

Most design and construction industry firms operate on thin margins and in an environment of risk/reward dissonance. While few firm founders and operating managers chose this industry from a love of finance and accounting, the dynamics of these businesses suggest that tight financial management is essential to long-term survival and success.

Ken Roper is a former CPA and owner of an accounting practice working with the construction industry and longtime consultant with FMI. In this conversation, Hank Harris asked Ken to share his perspectives on financial controls, what tools are most essential, and how a firm can best use the resulting information.

Ken Roper

Hank Harris

Hank Harris: Ken, you have worked in this industry for a long time and have seen many companies that are financially well-managed. What are some common indicators that show a firm is running a financially tight ship? What kinds of techniques and tools do you see employed to help companies do that?

Ken Roper: Most companies I see that are well-run have timely and accurate financial statements, and they don't make excuses for the process taking too much time. Financial statements are perishable. The longer it takes to produce them, the older and less valuable the information becomes. Companies that emphasize producing timely and accurate financial statements tend to be some of the best-run companies. These firms also have useful dashboards, offering the ability to take appropriate action based on what the metrics show them. The firm may have metrics for work in process or cash flow balances or collection problems or outstanding change orders. When any of those things show up on the dashboard as being out of line, it is time to take action. A useful dashboard has a system of identifying and reporting exceptions, versus trying to look at every piece of data generated by the financial reporting system. The firm may highlight specific items in their dashboard reports, including unassigned contracts, missing subcontractor insurance certificates, open claims or similar indicators.

Harris: Finance and accounting are timeless subjects. Your team, the FMI Management Consulting Group, doesn't evaluate financial controls the way a CPA would. However, you still use a score card to examine how the company is running its operations. Has the view of good financial controls changed during the last 10 years? Have there been any trends within companies in terms of financial control management?

Roper: There have not been big changes in this past decade. Our job as consultants is typically to look at the information produced and study the flow of data, as opposed to the financial controls themselves. To me, financial control means a system of checks and balances and segregation of duties — everything that CPAs typically handle. FMI looks at roles and responsibilities, and the qualifications of people to work in their assigned departments and capacities. Sometimes a firm has inadvertently assigned unskilled people or the wrong person to a particular position. FMI gets involved in these areas to help the

companies change or improve. This year I've been involved several times in helping the client find a qualified CFO. FMI's role has to do with structure, staffing and making sure that the people in a department are qualified, as opposed to only looking at financial controls. Getting the right people in the right place is key to success in any department.

Harris: You mentioned the importance of having the right talent. Certainly having the wrong talent is a red flag. Do other indicators, from a financial perspective, serve as potential red flags or areas of concern that something is not right?

Roper: When I taught my "Financial Management for Nonfinancial Managers" class, many participants asked, "What are the most important ratios?" This question was repeated every time we offered the program. To help formulate a good response to this question, I identified what I feel are the six most important ratios. These six are especially useful to nonfinancial staff because they are easy to compute and easy to understand:

- **Current ratio**, which measures the extent to which current assets can cover current liabilities.
- **Quick ratio**, which is the degree to which the most liquid current assets can cover current liabilities.
- **Leverage ratio**, which is debt to net worth.
- **Return on revenue**, which is the operating margin.
- **Return on equity**, which is return on investment.
- **Return on assets**, which is the utilization of capital.

An understanding of these six ratios offers a good, quick read of the important aspects of the firm's financial performance. There are benchmarks within the industry, so no matter the company's size, its performance can be compared to those benchmarks for a performance check. If any one of these ratios falls out of line with comparable industry averages, that should be considered a red flag by the firm.

Harris: There's an old saying that companies can be profitable but still go broke, which is generally a lead-in to talking about cash flow. What advice do you give to clients with regard to how they view their cash flow separately from the way they look at their profit and loss results?

Roper: I remember you saying that all sins are forgivable except for one: running out of cash. It's the job of the project manager not only to build the project correctly according to specification, but also to make sure that the firm makes a profit on the project. In addition to those two key roles, it is also very important to ensure that the cash flow stays ahead of the project cost.

Contractors should prepare schedules of values (project billing schedules) that promote cash flow ahead of project costs. That is just a training issue for most project managers, to ensure that billings and collections are done in a timely manner and monitored. One of the tools that we use with our clients is the liquidity indicator. This takes a select set of balance sheet accounts that project managers impact and analyzes the result to see if the company is generating cash flow from the work in process. The asset accounts, underbilling, inventories, accounts receivable and retainage receivables and the liability accounts payable, retainages payable and overbillings are compared. If the asset accounts exceed the liability accounts, then cash is applied to operations. The reverse is that if the liability accounts exceed the asset accounts, then cash is generated from operations. Looking at all of those on a project basis, a division basis and a company basis will show whether the firm is generating cash flow from construction operations. As an example, we used this liquidity indicator analysis with a big industrial contractor specializing in interiors for laboratories. We spent two years educating the firm's divisions across the U.S. and setting up worksheets for this liquidity indicator for each of them. Within that two-year cycle, the firm's cash flow improved by $13 million — for a $200 million company. Once a firm's management understands the cash flow drivers and what improvements are needed, these results are achievable.

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Harris: Firms have a variety of sources for advice on financial management of their operations. For example, they get certain advice from sureties, from consultants like FMI and from their bankers. How do you compare what these different advisors offer? Does this advice always line up, or are there differences?

Roper: The nature of the advice depends on two conditions: the financial condition of the firm and the motivation of the advice source. For the firm that has achieved sufficient financial strength that its sureties and banks no longer require personal guarantees, the advice will be different from that provided to

those firms whose creditworthiness still requires personal guarantees. In cases with no personal guarantee requirements, these relationships have evolved to this high level because the owners and the managers of the business have managed its financial position so that the business holds adequate assets to secure any financial loss that may occur. That is a very desirable place for a construction business to be in today — an unsecured position with the bank and the surety credit. The downside of this condition is that it is necessary to leave more of the capital in the business, which drives down some of the typical performance relationships like return on investment and return on assets. Businesses can sometimes have more capital than they need, but the tradeoff is that they can have the unsecured relationships. The banks always prefer to have more assets in the business that they can access. By contrast it is in the owner's best interest to move those assets out of the business to get them away from the risk inherent in construction activities, and to put these assets where they can generate additional adequate return. Surety companies want more held within the firm, and the owners, if they are looking after their own financial interests, want to move the assets out of the construction business. However, the firms that really excel and have a competitive advantage have left excess capital in the business, so that those relationships are sound and solid.

Harris: Have you seen any changes in contractors' use of debt or some other form of leverage since the recession began in 2008?

Roper: Contractors appeared to be using less leverage (debt) entering the 2008 recession. In fact, I've seen banks closing down lines of credit and cutting back on leverage at the beginning of the recession for those using lines of credit. One reason companies did well during this recession was that they were well capitalized as the economy entered the recessionary period. There have been some bankruptcies, but for the most part, companies have survived well.

Harris: That introduces the question of the overall health of balance sheets today. Most companies have been through a recessionary time and an anemic recovery. Have you seen evidence of a damaging effect to balance sheets, or are the balance sheets you see still relatively healthy?

Roper: We get to see many financial statements every year, both in FMI's peer groups and with our clients. Most firms took quick action to cut back on staffing, thereby minimizing their operating losses, making it at least possible to sustain a breakeven level, or, for some, generate a modest profit during the toughest years of the recession. This quick action limited damage to the balance sheets. The recession was still tough and the firms contracted in size — many firms emerged from the recession smaller than they were when it began — but they were able to sustain either breakeven or profitability, so their balance sheets came through intact.

Harris: Earlier in our conversation, you mentioned having the right talent. Small companies probably start out with a bookkeeper, and then, as they grow, they hire a controller. The bigger companies have CFOs (or all of the above). What are the differences among those roles, and how does a company know which is right for them?

Roper: I hope you were right when you said they start off with a bookkeeper and then they end up with a controller. Many companies try to continue to use a bookkeeper who gets overwhelmed pretty quickly by growth, and this situation can become an obstacle. The challenge is to find the resource needed to really help the business grow and evolve. That first step is a controller who is a technician — typically a hands-on person who does a lot of the day-to-day but doesn't supervise too many people (maybe up to a dozen people in the accounting group). Sometimes this person also handles human resources and similar functional areas. Generally, the span of control for a controller is somewhat limited. As the business grows and evolves in complexity (somewhere between $30 million and $50 million for a subcontracting firm and $75 million and $100 million for a general contracting firm), the need for a CFO arises. A CFO is a much more experienced financial person with between five and 15 years in the controllership function. The controller should have evolved with an organization of the same size or larger than the current company, so that he or she has the knowledge and experience to help get the firm to the next level. One of the mistakes in this area is to hire a $30 million CFO when the firm aspires to be a $70 million company. It should go the other way: hire the $70 million CFO to help grow the $30 million firm to a higher level. A more sophisticated CFO is required as the business gets more complicated and has more moving parts. A CFO oversees all of the financial aspects of the company, and the department size can vary from as few as five or 10, up to 50 to 100, depending on the number of divisions.

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Harris: Do you see companies failing to raise the talent level on this position because they are afraid to hurt the feelings of their longtime, loyal bookkeeper/controller, or because they're afraid to insert a new boss over them? Or have companies learned to get around that?

Roper: Yes, this still happens a lot. You have to appreciate the organizations that are really loyal to their people, but this is one area where you really need the confidence in the talent of your staff. Everybody is depending on these numbers and making decisions based on them, so you need someone who can do a good job of developing timely, accurate financial statements. Also, firms will need the processes and the procedures in order to change and evolve as the company gets bigger. You want someone that has that kind of sophistication and who can install systems, including hardware and processes and software, that will keep up with the business's needs.

Harris: How hard is it in today's market to access and hire financial talent?

Roper: It is certainly achievable. In fact, it's easier than in other areas of the business. I've been seeking out financial talent through a website called www.ConstructionExecutive.com. The response to CFO positions is much better than it is for operations managers, estimators or division business unit managers (all of which tend to attract fewer applicants than the CFO position). There's a wealth of talent out there, including experienced professionals and those who have grown up in public accounting and who are looking for private industry — yet have the qualifications to run a construction company. There is good availability for both controller and CFO positions.

Harris: Are there any other general points that you would like to offer our readers?

Roper: I keep going back to Doc Fails saying 60 years ago that contractors do three things: They get work, do work and keep score. You need to have exceptional performance in all three of those areas. Each one of them has unique challenges. If you start to deconstruct them and see what it takes to get work, do work and keep score, they are extremely complicated. If a company is going to excel, the CEO and the senior-level executives all must make sure that all three aspects are performing exceptionally well.

Harris: The proverbial three-legged stool…

Roper: It still applies today. **Q**

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