THE FINANCIAL ESSENTIALS OF STRATEGIC PLANNING

BY IAN RUSK

A good business planning effort should begin with a thorough financial analysis of the firm's performance.

I'VE HAD THE PRIVILEGE of participating in many strategic business planning sessions for A/E/C clients over the years. One thing I've noticed in many such sessions is that analysis of the firm's financial performance and setting financial goals usually get short shrift. In fact, more often than not, discussions of financial matters are often limited to a brief presentation by the CFO or controller, often at the tail end of the planning meeting (assuming any time is left). This is a mistake!

Let's back up a step and ask ourselves what the purpose of the business planning session is. The planning session, and the preparation that leads up to it, is our opportunity as business leaders to lift our heads up from our day-to-day work and assess what we are trying to accomplish as a business enterprise (our vision or mission), objectively assess how we are doing, identify ways that we may improve, and ultimately lay out an action plan with measurable goals and clear responsibilities.

An Objective Perspective

That first step—the objective assessment of how the firm is doing—can take many forms. We might survey our clients about their level of satisfaction with our services, or we might look inward and survey our own staff to identify any managerial or workplace issues that need to be addressed. But the most quantitative answers to the question of "how we are performing as a company" lie in the numbers, and as the saying goes, numbers don't lie.

To illustrate my point, let's pick a problem that many firms might find themselves dealing with in our current economic climate: employee turnover. Employee turnover is actually not the problem itself, but rather an observable symptom of an underlying issue. That issue might actually be a lack of perceived upward mobility on the part of your staff, overwhelming workloads, interpersonal conflicts, etc. Calculating the turnover rate itself neither identifies the issue nor quantifies its impact on the organization. However, you should be able to quantify the impact of this and other "issues" your firm may be facing through some simple financial analysis.

The impact (if any) of employee turnover should manifest itself in measures such as the firm's utilization rate (chargeability), training and development costs, effective labor multiplier, and ultimately its profit margins. These are all financial metrics—that is, metrics derived from the firm's financial statements (income statement and balance sheet). And, unlike a simple employee turnover rate calculation, these metrics will allow you to quantify the economic cost of the issue, which in turn will advise how much time, effort, and expense you ought to be devoting to correcting it. You might find, for example, that utilization has dropped three percentage points over the last year as a result of the increased turnover. And that, based on your size and billing rates, translates into $50,000 in lost revenue.

A good business planning effort should begin with a thorough financial analysis of the firm's performance. We recommend looking back over the last three to five years, even if you perform such analysis annually, as it will allow you to identify trends and put your financial performance and condition into an historical perspective. For further perspective, we recommend benchmarking your firm against your peers. Peer data is readily available through a variety of sources. When assisting our clients, we like to use benchmarking data from ZweigWhite's annual survey publications because of the level of confidence we have in how the data has been compiled, as well as our ability to access the underlying database to make the most meaningful peer-to-peer comparisons. In this sort of analysis, an "apples-to-apples" comparison—or as close to it as you can get—is crucial.

Peer benchmarking data will tell you where you lag behind industry norms and where you excel. This sort of analysis, when overlaid with more qualitative data, can be truly insightful, helping you to identify the issues that are having the most economic impact on the firm. This will allow you to prioritize your business planning efforts and resources. Financial metrics can then be used to set goals and measure real progress over the course of the year.

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Analyze This!

Below is a guide to the sort of financial analysis that should precede your business planning efforts:

Revenue growth. Begin with the income statement. How have net service revenue levels (gross revenue less reimbursable and sub-consultant expenses) changed over the course of the year? What factors or efforts are driving the revenue growth, or causing a decline? If external economic factors are an influence, how can you capitalize on the opportunities they represent, or mitigate the negative impact of a poor economy?

Profit margins. The most meaningful measure of profitability is on a pre-tax, pre-discretionary distribution basis, stated as a percentage of net service revenue. How does the firm's profit margin compare to its peers? What has the trend been (increasing or declining)? What factors have been impacting profits? Sometimes the answers are obvious, but other times it's difficult to understand what factors are having the most impact on profits. When this is the case, analysis of several financial metrics can help.

Revenue factor. This is the ultimate litmus test of an A/E/C firm's performance. It represents the amount of net service revenue earned for every dollar of payroll (not including payroll benefits and taxes), which represents your largest expense category. How does this compare to your peers? What has been the trend within your firm? Determining the cause of a high or low revenue factor can be easier if the metric is broken down into its two components: utilization and labor multiplier.

Utilization, or chargeability, is the measure of direct (billable) labor cost to total labor cost. Higher utilization rates increase the revenue factor and typically result in above-average profit margins. A low utilization rate can be a symptom of many things. It could reflect a top-heavy firm with too many principals in unbillable roles. It could also reflect a firm that's simply overstaffed.

Very high utilization rates can also reveal potential issues. Firm-wide utilization rates well in excess of industry norms can point to tough working conditions and an unsustainable workload. While the firm may be enjoying the economic benefits at the moment, it could see negative ramifications in the long run.

The other element of the revenue factor, the labor multiplier, measures the relationship between net service revenue and direct (billable) labor costs. The multiplier a firm is able to achieve can reflect the value of its services in the marketplace, the competitive environment, and the efficiency of its staff.

We've found that firms with very high multipliers are often operating in a niche where they enjoy a significant competitive advantage or have established themselves as experts in one or more very specialized services or project types. In contrast, firms that have low multipliers are often providing undistinguished commodity services or operating in markets with very high competitive pressures. Understanding what factors are influencing your firm's multiplier will help guide your strategic planning—allowing you to sustain a strong multiplier—or take steps to address a weak one.

Overhead rate. This ratio measures the relationship between overhead expenses (including non-billable labor) and direct (billable) labor. If you do public-sector work, don't confuse this metric with your audited overhead rate under Federal Acquisition Regulations (FARs). What this metric illustrates is your firm's level of indirect (non-billable) expenses in relation to direct labor cost. There are many issues that can contribute to a high or low overhead rate, and you may have to take a deeper look at the various categories of operating expenses on your income statement to understand what's influencing your overhead rate.

We often find that small firms with multiple offices have high overhead rates due to the difficulty in keeping multiple offices fully occupied and the inefficiencies of managing staff in multiple locations. A low utilization rate will also have a big negative impact on a firm's overhead rate. The overhead rate is a metric that tends to fluctuate significantly as a firm grows and hits points where it must make significant investments in overhead expenses to support continued growth, such as hiring an HR director or investing in new software or hardware.

Average collection period. This metric is an indicator of cash flow. It measures the amount of time it takes to convert accrued revenue to cash. We've observed many cases of otherwise successful firms being crippled by poor cash flow, so don't ignore this aspect of your financial performance. A poor average collection period may point to procedural inefficiencies with invoicing and collections, poor project management discipline, or even project delivery problems.

Balance sheet analysis. Take a hard look at the makeup of your balance sheet and how your firm is capitalized. How much debt are you carrying in comparison to your equity and/or your total asset base? What is the ratio of your current assets (assets that can be converted to cash within one year) to current liabilities (obligations that must be paid within one year)? This is sometimes referred to as liquidity.

How to capitalize a growing firm is one of the most important strategic decisions you can make. Growth inevitably requires investment in both working capital and fixed assets. Analysis of the current state of your balance sheet will help you make an informed decision as to what sources of capital to use. Should you make more use of bank financing, or should you seek to raise equity capital by creating more ownership opportunities for key staff?

You should also examine what liabilities the firm may have that do not appear on the balance sheet. For example, does the firm have upcoming stock-redemption liabilities (i.e., retiring shareholders), and how do you plan to manage those obligations?

Other Indicators

Of course, there are many other financial indicators that you could and should be examining as part of the business planning process. We've only scratched the surface here. But hopefully, this illustrates the value of conducting a thorough and thoughtful financial analysis of your firm as part of your business planning preparation. Doing so can help you assess your relative strengths and weaknesses, identify underlying issues to be addressed in the planning process, and set measurable goals for tracking the effectiveness of the initiatives that you take. MSC

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