AS THE ECONOMY STRENGTHENS, CONSTRUCTION FINANCIAL PROFESSIONALS HAVE AN EXCITING OPPORTUNITY TO DEMONSTRATE FINANCIAL LEADERSHIP, ADD VALUE, AND ENHANCE THEIR INFLUENCE AND CREDIBILITY WITHIN THEIR ORGANIZATIONS.
The challenge many CFMs face today is that they are too often seen as the company “historian” who is focused on what happened in the past as well as control and compliance. However, you can turn your role – and that of your accounting department as a whole – into a valuable strategic asset on which management relies.

You have an incredibly powerful tool in your toolkit: a reliable financial forecast. Creating a forward-looking view of financial performance is the secret for turning financial information into valuable insight. Providing insight to your leadership team helps you become part of making history rather than just recording it.

This article will show how to tap into the unique and exciting benefits that financial forecasting can unlock for you, your company, and your career.

The Monthly Financial Rhythm

Just as a construction business moves in a rhythm or cycle, so does its financial management. As you can see in the illustration on the next page, it’s about setting financial goals and targets, monitoring forecasts and actual financial results, and making adjustments in strategy and execution inside the business when results differ from the target or expectation.

A monthly rhythm orchestrated by the CFM provides financial feedback and improves decision-making within the company.

Target

A target is a key financial goal that is derived from the company’s vision and strategy, and can change depending on short-term financial goals. For example, one quarter might have specific goals related to collecting receivables faster, while another quarter might include a focus on increasing project margins or reducing certain expense categories. There are generally 3-5 targets at any time, and the mix of targets/metrics may vary during the year.
Monitoring is about creating financial forecasts (expected financial results) and actual results (historical financials). The combination of the forecast and actual results must be converted into insight (not just numbers or financial statements) for the management team.

Adjustment
Management then uses insightful financial information to determine whether the specific action plans and strategies being executed throughout the company are working as expected. The management team is on board because they understand the financial goals and related metrics being tracked. You have helped them learn how to use the monthly financial information to compare the actions taken in the field to the implications in the financial statements.

Now, management has a tight link between their plans and the actual financial results. Adjustments to strategies and tactics in the field can be made quickly when the financial information suggests something is not working as intended.

Construction projects move in this same rhythm. To bid on a project, the specific goals are evaluated and agreed upon. Then, financial targets are set to document the scope and arrive at the price. As a project progresses, accounting provides actual results for the project against the plan so that PMs and others can evaluate results and determine if adjustments need to be made as the project moves toward completion.

Once the project is complete, management must evaluate whether the profit targets for the job came in as they were forecasted/planned. That way, the bidding process can be improved based on the lessons learned from each completed contract.

This same financial rhythm is at work at the overall company level as well.

Financial Forecasting
Notice how the monthly financial rhythm begins with the financial goals and targets being defined and turned into a financial forecast. The forecast at the overall company level captures the financial expectations in the form of the key drivers of performance as well as an income statement, balance sheet, and statement of cash flows. Then, actual financial results are created and compared with the forecast to turn the financial information into insight for management.

The problem is that, as accountants, we were taught that our mission is to gather and record transactions so we can create historical financial statements. The historical financial statements show actual results for a specific period and present the financial position at a specific point in time (both of which are in the past). No doubt that is an important part of your role, but it’s putting the cart before the horse from a business and financial management perspective.

A person leading a construction business is trying to make something happen. He or she has a plan for what the business should accomplish and starts with expected financial results, not actual financial results. Historical financial information only becomes insightful when it shows how actuals compare with expected results.

Enhance Your Influence & Credibility
Financial forecasting will change the way you are perceived by the leadership team in surprising ways. Each step in the forecasting process draws you into more value-added activities.
There are three phases to the process of creating a financial forecast. First, consider the company’s goals and strategies as well as its financial history. Next, begin creating the actual forecast—an expectation of what the income statement, balance sheet, and cash flows will look like based on your assumptions about the near future. In the third phase, begin using the forecast to help management make decisions. This is where you turn financial information—both the forecast and the actual results—into valuable insight.

Here’s how the three phases unfold.

**Phase 1 – Understand the Vision & Strategy**

One of the benefits of forecasting is that it makes you think about your company’s vision and strategy. For example, what are the three most critical goals or initiatives for the coming year? Is the company planning to grow slowly or aggressively? Are there plans to bid on projects similar to the ones in the past, or is the company moving into new markets or new types of construction? Answering these types of strategic questions forces you to “get out of the ledger” and talk to management about the division’s goals or the department’s strategies. It requires you to talk to the CEO about his or her vision.

Now, you’re talking about the larger goals and direction of the business with management throughout the company. You’re thinking about the future rather than just the past. You begin to piece together a much clearer picture of where the company wants to go. Your understanding of the company grows. You’re thinking more like a CEO, and the leadership team begins to notice.

**Phase 2 – Define What Is Likely to Happen Financially**

As you formulate the forecast assumptions, you must link the goals and strategies of the business to what you think is likely to happen financially. The intersection of the company’s goals and strategies and your conclusions about what’s actually going to happen is fascinating. You have to forecast profitability, cash flow, and financial position. You’re not forecasting what someone wishes would happen, but rather what you believe will most likely happen based on your understanding of the business.

Let’s say your company is a commercial GC and one of management’s goals is to increase gross margin from 13% to 18%. You look at the work-in-progress (WIP) schedule, and 18% is a huge stretch based on existing projects. You talk with the CEO and others on the management team about the details behind the strategy to increase gross margin to 18%. Is the company planning to bid on different types of projects? Is it increasing prices? Will the company reduce subcontractor costs?

These types of discussions will help to adjust either the goal or the action plans necessary to turn the improvement goals into financial reality. Regardless, you will have led a forward-looking discussion with management that creates value for them and the company.

**Phase 3 – Turn Numbers into Insight**

Now that you have the forecast up and running, it’s time to turn those numbers into insight for management. The challenge is that now you have twice as many numbers to review. Let’s include this on our agenda for next week’s financial review so we can talk in more detail about whether the gross margin target of 18% for this year is in jeopardy or whether there are steps we can take to increase margins faster.
present – a full set of financial statements for the coming months plus the historical financial statements. So, think strategically; put yourself in management’s shoes. What do they think about every day? How can you distill the essence of your financial information into something that’s simple and easy for them to understand and digest? The information you provide should be viewed as an integral decision-making tool. The key here is to simplify, simplify, simplify...then simplify some more. Consider summarizing the top 3-5 insights when you distribute the historical and forecast results. And, highlight the key drivers of performance so it clearly shows if the actual results are not aligned with the expected results. The information you provide should be viewed as an integral decision-making tool.

The key here is to simplify, simplify, simplify…then simplify some more. Consider summarizing the top 3-5 insights when you distribute the historical and forecast results. And, highlight the key drivers of performance so it clearly shows if the actual results are not aligned with the expected results. That way, management can quickly see the link between their areas of responsibility and the impact their actions have on the financial statements.

The sample memo on the previous page is an example of an insight (a focus area) that might be included in what you send to management. Based on the prior example of a target to increase gross margins from 13% to 18%, this memo would go with the monthly financial reporting package.

Although the financial reporting package would include all the financial statement details for management to eventually realize the gross margin target was in trouble, the summary simplified it, summarized it, and made it easy to understand and action-oriented. Sometimes it only takes a couple of paragraphs to turn financial information into insight.

### Five Rules for Creating a Forecast You Can Trust

Creating a reliable financial forecast does not have to be a difficult process. It’s a matter of using a few basic principles together with your intuition and knowledge about the business. Here are five rules for creating a forecast that you can trust.

**Forecasting Rule No. 1: Think Decision-Making, Not Precision**

One thing stopping you from creating a forecast is thinking that you don’t know exactly what the future holds and what will happen if your forecast is wrong. Transaction processing and creating historical financial statements is about being right. (Here, precision is your friend.) On the other hand, forecasting is about improving the company’s ability to make wise decisions. (Here, precision is your enemy.)

Let’s say your CEO told the bank and outside investors at the beginning of the year that the company’s plan was to increase pre-tax income to $1.2 million and reduce debt by $750,000 this year. Results for the first half of the year came in better than budget and management is feeling confident. It’s mid-year and you are updating your forecast for the remainder of the year.

From a decision-making perspective, the question is whether or not the company has a good chance of hitting the pre-tax income and debt reduction targets. If the company is likely to hit the targets, then management should focus on continuing to execute the existing plan. If the targets are in jeopardy, then management needs to evaluate what’s not working and make changes now to get back on track.

After you review the WIP schedule and a summary of bids outstanding, it becomes clear that the second half of the year is likely to come in far below the first half. The forecast summary above displays these results as compared to the prior year and the plan for this year.

Is a forecast always right? No. Is pre-tax income likely to come in at precisely $800,000? No. From a precision perspective, questions will arise. (How much might a specific project go over budget? Which bids will actually turn into projects? Will there be employee turnover that could disrupt project
completion dates and costs? Will a specific customer be able to pay its invoice by the due date?) The answers to these questions along with a host of other details will all impact the precision of your estimate of pre-tax income and cash available for debt reduction.

But what is very clear in the forecast is that there is a substantial risk of missing the pre-tax income and debt reduction targets for the year. Based on the forecast, management’s attention is required to get the company back on track for the second half of the year.

Chasing precision will only serve to cloud the message and distract from the importance of getting the company back on track to meeting its financial goals.

As you create and use forecasts, think decision-making, not precision.

**Forecasting Rule No. 2: The Near Future Almost Always Looks Like the Recent Past**

One of the biggest mistakes CFMs make in creating a forecast is to start with a clean slate – a blank spreadsheet to begin thinking about what the first month in the forecast will look like. The first step should be to drop in actual results for the past 6-12 months. Have the revenues and expenses been coming as expected? Can you see a trend developing? Are you surprised by any of the numbers now that you are looking at the past six months of actual results next to each other?

In order to increase the reliability of the forecast, the historical facts and trends and the company’s goals and financial targets must be considered together when you create the forecast.

**Forecasting Rule No. 3: Consider What Is Changing**

Once you have a good view of what the financial results have been over the past 6-12 months, look at some of the factors that can make the next 6-12 months vary from the historical results. The WIP schedule is a great source of information (e.g., what revenues and cost of sales you can expect over the next few months).

Then, consider the types of outstanding bids. Are they targeted at construction projects similar to those in the past? Are they for smaller or larger projects? Are the gross margins consistent with current projects, or are they higher or lower?

Think through how the business is changing and its likely impact on financial results and cash flow. Talk to PMs and others about what they are seeing in the market. Does customer activity seem to be picking up or slowing down? Management and others inside the company are a wealth of information that will shed light on what’s changing and what’s about to happen.

**Forecasting Rule No. 4: Be Conservative**

Because we know the forecast will not be perfectly accurate, the challenge is keeping it in the “ballpark” since a wildly inaccurate forecast will hurt your credibility. Therefore, be conservative in your key assumptions.

Let’s say you are working on the profitability component of your forecast. Last year, the company generated $6.5 million of net income. This year, profits could reach $10 million if results continue the way they have been going. Being conservative in your forecast of profitability means that you assume there could be some slips or slow downs before year-end. So, your forecast might guide the profit estimate down to around $9 million, which provides some room for error or surprise. It recognizes that not every “at bat” results in a home run.

While your estimates will not be perfect, err on the side of being conservative. That way the surprises are pleasant rather than unpleasant.
FORECASTING RULE NO. 5: USE THE “SMELL TEST”

An important step in mitigating risk when creating a forecast is to give it a serious reality check, what I like to call a “smell test.” You’ve created assumptions about profitability, the timing of collecting A/R, inventory and payables, capital expenditures, borrowing or payments on debt, distributions to owners, and a number of other important drivers of financial results.

Once you have a completed draft of the forecast, step back and look at the resulting financial statements. Are they consistent with your general expectations? Are they in line with actual results and the plan? Do they make sense given your intuition and knowledge of the business?

When forecasting a full set of financial statements, the real bottom line is cash. So take a hard look at the resulting cash balances for each of the forecast months, and look at both the numbers and a graph of the resulting cash balances.

In the graph below, the actual cash balances for the past six months and the forecast cash balances for the next six months are presented. Because every forecast assumption you make ultimately impacts the cash balance, pay very close attention to the forecast cash balances to ensure nothing looks unusual. The smell test is a quick way to check that nothing unexpected has made its way into your numbers.

Don’t Just Report Profits, Build Them

At the beginning of CFMA’s Cash Management course, Steve Lords starts by saying, “It is possible for a construction company’s Controller/CFO to generate more profit for the company than a PM does on a construction project.”

It is a bold and spirited statement designed to jolt us out of our traditional thinking as CFMs. We’re not PMs. We’re not estimating the jobs before the bidding process. We’re not out in the field making the day-to-day decisions on the job. Yet, we can “generate more profit for the company than a PM does” on a project. How is that possible? It’s because we have the facts, we know the numbers, and we have a clearer view of what’s about to happen financially than anyone else in the company.

Right now is the ideal time to participate in the building of profits, not just the reporting of results. And when the economy weakens, as it will surely do at some point in the future, we need to be prepared to actively participate in protecting profits, not just delivering the bad news after the fact.

Remember, your role is not just about providing a view of the past. It’s about adding real value and making a difference in the company’s mission and ability to make money and grow. It’s about presenting financial information in a way that turns numbers into insight. Financial forecasting is a great way to jump-start that process.

PHILIP CAMPBELL is a financial consultant based in Austin, TX. He has been working closely with CEOs and owners for more than 30 years.

As a consultant, Philip is focused on helping leaders keep the accounting and financial side of their business strong and providing the insights needed to improve cash flow, get access to capital, and grow successfully.

He is the author of the book Never Run Out of Cash and the online course Understanding Your Cash Flow in Less Than 10 Minutes.

Phone: 512-944-3520
E-Mail: pcampbell@pdq.net
Website: www.neverrunoutofcash.com