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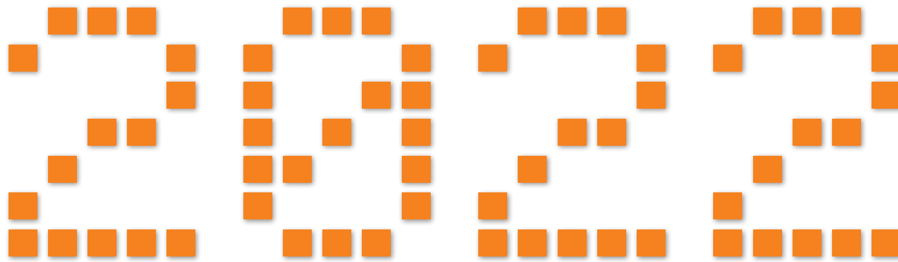

2022 YEAR-END PLANNING

BY DANIEL GASTON

2022 HAS CONTINUED TO BRING THE SAME UNCERTAINTY as the past couple of years — with both familiar and brand-new reasons. While there are continued pockets of pandemic-related fallouts, most notably supply chain issues and increasing inflation, the war in Ukraine has further destabilized the global markets and supply chains.[1]

This article highlights changes and updates from 2022 and dives into their impacts and other expectations as we head into 2023.

The Federal Reserve

This time last year, the Federal Reserve had taken the position that the inflationary pressures felt across the country were transitory.[2] It has since changed course and increased the federal funds rate (as of publication) six times in 2022 as a way to combat inflation.[3] The effects in the construction industry include increasing costs of capital for construction contractors as well as financing difficulties for owners.

Updates From Washington

Infrastructure Investment & Jobs Act

Signed into law in November 2021, the *Infrastructure Investment and Jobs Act*[4] provides approximately $550 billion in additional funding for public infrastructure.

The effects of this bill have yet to be seen by many, but there is optimism as funds are beginning to be released and projects bid.

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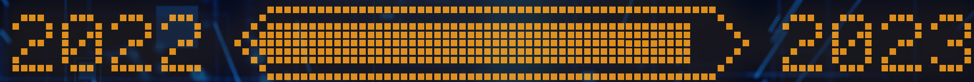

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Inflation Reduction Act of 2022

In August 2022, the *Inflation Reduction Act of 2022* was signed into law[5] and contains more than $5 billion to incentivize the use of low-carbon building materials in public infrastructure projects.[6] Additionally, the bill expanded federal energy efficient tax incentives — the 179D Deduction and a new alternative, as well as 45L Tax Credits, as amended by §13303 and §13304, respectively.

179D Deduction: Energy Efficient Commercial Buildings Deduction

The 179D Deduction allows for government-owned building owners to allocate special tax deductions to the architects, engineers, and contractors responsible for designing the building's energy efficient systems that have been modified.[7]

The prior credit amount of $1.80 per square foot[8] is modified by §13303(b)(2) of the *Inflation Reduction Act of 2022* to a base of $0.50 plus $0.02 for each percentage point by which the total annual energy costs of the building are certified to be reduced by more than 25%. In addition, the total amount cannot be in excess of $1.00.

If the taxpayer also can show certain apprenticeship and prevailing wage requirements have been met, those amounts are increased from a base of $0.50 to $2.50 and from $0.02 increment increases to $0.10 allowing up to $5 per square foot total. Deduction amounts are limited to the total cost of the energy-efficient property.

Alternative Deduction for Energy Efficient Building Retrofit Property

There is also a new alternative to the 179D Deduction called the Alternative Deduction for Energy Efficient Building Retrofit Property (also presented in §13303).

In order to qualify, the building must have been in service for at least five years before the retrofit plan is established and be located in the U.S. Eligible retrofit costs include interior lighting; heating, ventilation, and air conditioning (HVAC); and hot water systems or building envelope.

The retrofit plan must call for at least a 25% reduction in the building's energy use and certain milestones by a qualified professional. The Alternative Deduction for Energy Efficient Building Retrofit Property can only be claimed *after* the building is in service for one year and the reduction in energy is known. It is also capped at the cost of the retrofit expenditures made and is only effective for property placed in service after December 31, 2022.

45L Tax Credits: New Energy Efficient Home Credit

According to §13304 of the *Inflation Reduction Act of 2022*, the 45L New Energy Efficient Home Credit is extended through 2032. The credit had expired at the end of 2021, but the old 45L credit is extended for homes sold by the contractor in 2022.

The new credit amounts and other modifications will apply for dwelling units acquired from the contractor after 2022. This law creates a new category of qualified dwelling units that are eligible for a $5,000 credit, which is a home that qualifies as a zero-energy ready-made home under the Department of Energy guidelines. Most other single-family units that qualify will receive a $2,500 credit.

Dwelling units that are part of a multi-family building are eligible for smaller credits unless certain employment and wage standards are met. Under the prior New Energy Efficient Home Credit, the maximum credit was $2,000.

Bipartisan Infrastructure Law

In addition to these changes, there continues to be increasing regulation at the state and federal levels. The *Bipartisan Infrastructure Law* includes Build America, Buy America guidance that expands domestic sourcing requirements, known as Buy America, for construction materials on all federal-aid transportation contracts, among other things.[9] Given current supply chain issues, the Buy America provision could have unintended consequences.

Ongoing Supply Chain Challenges

The supply chain challenges appear to be ongoing for all industries, particularly construction; the many layers of the construction supply chain include labor, materials, finished materials, subcontractors, and consultants. Organizations should understand their own specific supply chain, identify and understand their risks, and implement procedures where possible to reduce those risks.

Materials procurement is an issue with which all construction financial professionals (CFPs) have likely been dealing. Prior to the pandemic, raw or finished materials would be ordered and delivered to the jobsite when expected. But now, materials need to be ordered with significant lead times to ensure that jobs stay on schedule. In addition to long lead times, contractors need to scenario plan for slipping delivery dates on material and equipment. Thanks to chip and other component shortages, delivery dates are consistently missed. This has

presented additional challenges with inventory and material management, tracking, and purchasing.

Often, it is the PM's responsibility to procure the various materials for their respective jobs. As a result, each PM may use a different supplier and get different pricing. Additionally, PMs are now spending more time than ever to ensure materials arrive to jobsites on time to avoid project delays. There can be a silver lining to this in that previously, some prefabrication and modular techniques didn't generate significant savings. Because these techniques save time, they are now being looked at more than ever.

Exhibit 1: **Working Capital Overview**

Current Assets	
Cash	10,000,000
Contracts receivable	50,000,000
Contract assets	
Contract retention	20,000,000
Costs and estimated earnings in excess of billings on uncompleted contracts	2,000,000
Other	1,000,000
Total current assets	83,000,000
Current Liabilities	
Current maturities of long-term debt	1,500,000
Accounts payable	60,000,000
Contract liabilities	
Billings in excess of costs and estimated earnings on uncompleted contracts	10,000,000
Other	1,000,000
Total current liabilities	72,500,000
Working Capital	10,500,000

Exhibit 2: **WIP View of Cash Flow**

Contract price	25,000,000
Total estimated cost	20,000,000
Profit	5,000,000
Costs to date	12,500,000
Percent complete	63%
Revenue earned	15,625,000
Billings to date	18,000,000
Billings in excess of costs and estimated earnings	2,375,000

Centralized Procurement Function

At first glance, a company may shy away from a centralized procurement process because of the perception that the additional overhead associated with a dedicated procurement function is not affordable. However, construction companies that have been thoughtful in implementing a centralized procurement function have found cost savings, as there is often waste and inefficiencies in a decentralized process.

There is also additional purchasing power with suppliers and the opportunity for better and more reliable terms. Many construction vendors are beginning to request more unfavorable payment terms, and sometimes a significant down payment is required for materials and equipment. Because of this, it is difficult to pass along the change to the owner or other trade partners.

A centralized purchasing function allows PMs to devote their time to managing the various aspects of the projects, so they are executed as they were planned and bid.

Planning for a Downturn

Are we currently in a recession?

The Architecture Billings Index (ABI), a leading indicator for nonresidential construction, has been over 50 thus far in 2022. A score greater than 50 indicates that architecture firms are reporting an increase in billings from the prior month, and a score less than 50 indicates that firms are reporting a decrease in billings from the prior month.

Exhibit 3: **True Cash Flow View**

Cash inflows	
Billings	18,000,000
Less	
Accounts receivable	(6,000,000)
Retention	(1,350,000)
	10,650,000
Cash outflows	
Costs to date	12,500,000
Less	
Accounts payable	(1,000,000)
	11,500,000
Net cash position	(850,000)

However, "Another quarter has brought with it further declines in confidence among the nation's leading construction financial professionals," according to CFMA's CONFINDEX survey.[10]

Regardless, there are headwinds with continued inflation, rising interest rates, and continued supply chain issues. There will continue to be instances of owners cancelling and delaying projects due to prices exceeding the initial estimates. So what should CFPs do?

Construction is typically a lagging industry when entering a recession; although the pain may be felt later than in some other industries, now is the time to plan because once a recession hits and the backlog has been worked through, tough decisions will lie ahead.

Many organizations have been focused on building an internal infrastructure to support growth over the past several years. Organizations should take a look back in history to understand the lessons learned from previous downturns in the economy.

Discussions with many CFPs during this past year show that construction companies are beginning to focus more on profitability than growth. This has led to contractors implementing or reevaluating their go/no-go processes when pursuing work.

Construction contractors are becoming more selective regarding which projects they take on and who they work with. Some are even building significant contingencies into bids for jobs with an owner or trade partner who has been difficult to work with in the past. Additionally, depending on the project's duration, more contingencies related to pricing and ongoing inflationary pressures are possible.

With this focus on the bottom line, look to enhance your current processes, such as monthly reviews of the work-in-progress (WIP) schedule and job status, and engage with operations on a regular basis to understand the status of jobs and potential issues. It is helpful to understand what those issues are and if there are proper contingencies or strategies to mitigate them, such as significant unapproved change orders.

During a downturn and times of significant growth, there needs to be a focus on cash flow. Some CFPs look at cash flow on a global basis by looking at working capital, but understanding the various components of working capital related to the jobs that could mask a cash flow issue is also critical.

Examining Cash Flow

At first glance, the scenario presented in Exhibit 1 looks positive, as working capital has a $10.5 million surplus. Stopping at this factor could mean missing potential issues within individual jobs.

In taking a closer look at a hypothetical job for this same company (Exhibit 2), this could look like a good job if you're ***only looking at the WIP schedule***. In this scenario, there appears to be good margin in the job, and it's in an overbilled position. But what if you took a deeper look at this job and discovered the following additional facts?

- Accounts receivable (A/R) balance: $6 million
- Retention balance: $1.35 million
- Accounts payable (A/P) balance: $1 million

If you were to evaluate the true cash flow on this job (Exhibit 3), then you may be surprised. Start by figuring out the net cash inflows by taking the billings to date less the A/R and retention balances. Next, look at the net cash outflows by taking the actual costs to date less A/P.

Doing this shows that this job is in a negative cash position. When reviewing the A/R aging schedule, it can be found that $4 million of the total A/R balance is over 90 days outstanding.

The hypothetical CFP then discusses the issues with the PM and finds that the customer is unhappy with some of the work, which is why there is a delay in payment. Upon further discussions, the CFP becomes aware of $2 million of unapproved change orders that is included in the estimated contract price of $25 million for work that has already been performed.

Unfortunately, this is a common scenario, but doing a deeper dive into understanding the cash position of each job and attending monthly job reviews — where discussions around the job status and potential issues occur, such as the ones in the previous example — can help identify these issues sooner. This would allow the company more time to be proactive in responding to these challenges and hopefully mitigate the risk of loss.

ASC 842: Leases

For calendar year-end companies, the Financial Accounting Standards Board's (FASB's) new lease standard Accounting Standards Codification (ASC) 842 is effective for the year ending December 15, 2022.[11] The new guidance[12] requires

lessees to recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use asset. Bright-line tests have been eliminated and management judgment will increase.[13]

The FASB has also updated the lease definition, and some contracts that are not currently accounted for as leases may now be considered leases under ASC 842. Less dramatic, but substantial, changes were made to the lessor accounting model to align it with changes to the lessee model and ASC 606 revenue recognition standard. Leveraged lease accounting has been eliminated, although grandfathered for existing arrangements.[14]

The guidance on related-party leases has changed; under ASC 840, related-party leases are based on the substance of the arrangement, whereas ASC 842-10-55-12 bases them on legally enforceable terms and conditions.

Exposure Draft

The FASB recently approved an exposure draft[15] that addresses some issues that have arisen with related-party leases.

Written Terms & Conditions

The proposal would amend ASC 842 to specify that an entity would consider only written terms and conditions. An entity would not be required to determine whether those written terms and conditions are legally enforceable.

If no written terms and conditions exist, then an entity would continue to apply the existing ASC 842 requirements. That is, an entity would need to consider legally enforceable terms and conditions (oral and implicit) for purposes of determining whether a lease exists and, if so, the associated classification and accounting of a lease.

Consistent with ASC 842, if no legally enforceable terms and conditions exist, then the arrangement would not be considered a lease and other GAAP would apply.

Leasehold Improvements

Additionally, the proposal would amend ASC 842 to specify that leasehold improvements for leases between entities under common control be amortized by the lessee over the improvement's useful life (regardless of the lease term). This would be the case as long as the lease continues to use the underlying asset and is accounted for as a transfer between entities under common control if and when the lessee ceases using the underlying asset.

The details of the changes related to related-party leases are subject to change pending the release of the exposure draft.

New Opportunities

Adoption of the new standards provides a few new opportunities. With the changes in the accounting for leases, many organizations will see a significant change to their balance sheets with the addition of the right-of-use assets and liabilities. This change has been an opportunity for CFPs to engage in discussions with the users of their financial statements — especially banking and surety partners.

Many organizations have debt covenants that may be tied to metrics such as working capital, current ratio, tangible net worth, and debt to tangible net worth.

Hopefully you have already engaged in discussions with your advisors about the changes to your financial statements.

The economics of the leasing transactions have not changed, but the accounting for them has, which presents difficulty in applying a consistent comparison to some of these ratios when compared to historical levels. Some organizations and their banking partners have struggled with resetting these benchmarks.

Another option that has been seen as successful is to change the definitions in the agreements so the ratios would exclude the right-of-use liability related to what has historically been an off-the-books operating lease.

Additionally, there are other opportunities when evaluating the various lease agreements. Pay careful attention to the terms in the agreements and look for unfavorable language. There could be issues if the pricing and terms are no longer consistent with your organization's current strategy and the economic environment.

After reviewing the various lease arrangements, take note of how many partners with which your organization works. Is there an opportunity to have a more centralized leasing function in order to obtain better terms and reduce the amount of time working with several different leasing organizations?

If you haven't begun the process of implementing the new lease standards, don't wait any longer. There are various software tools that can assist organizations with the accounting for the initial adoption, ongoing monthly entries, and summarizing the information for the required disclosures. There are also third parties that can assist with the implementation process.

Conclusion

Construction companies and their CFPs face many challenges ahead with the continued supply chain issues, rising costs and interest rates, new accounting standards, tax law changes, and new regulations. Take time to reflect on this past year before looking forward to 2023 and beyond by asking:

- What have you learned this past year?
- How can you capitalize on the opportunities ahead and minimize the potential headwinds related to uncertainties in the markets and the tax and regulatory environment?
- What processes and strategies need to be reevaluated?
- What proactive approaches can you take to better manage current and future project risks?
- What does success look like for you and your organization going forward? ■

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