Executive summary | Roundtable XV, June 14, 2022

Wipfli Construction CFO Peer Exchange

Host: Reed Sellers | Wipfli
SMEs: John Helmuth and Bill Hughes | Wipfli
Facilitator: Austin Evans | Profitable Ideas Exchange

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Introduction

Fourteen chief financial officers (CFOs) from the construction industry met virtually to share leading practices and discuss topics of mutual interest based on an agenda created through a series of pre-interviews.

From Wipfli, Reed Sellers, partner; John Helmuth, partner; and Bill Hughes, partner, hosted the exchange, and Austin Evans of Profitable Ideas Exchange facilitated.

The focus of the discussion covered the following topics over the course of the hour:

- Changes to lease accounting
- Market considerations
- Subcontractor concerns
- Inflationary impacts

Changes to lease accounting

- John Helmuth of Wipfli opened the conversation by providing a brief overview of the changes made to lease accounting, which requires the recognition of leasing activity on the balance sheet.

- The most significant change for lessees is the recognition of both a lease liability representing an entity's obligation to make lease payments and a right-of-use asset representing an entity's right to use the underlying asset for the duration of the lease term for leases classified as operating leases.

- Depending on the entity's leasing activity, the gross-up on the balance sheet may have a significant impact on financial ratios and debt covenants, including debt-to-equity ratios, current ratios and working capital. Consider meeting with your lenders to discuss the potential impact on your financial statements and debt covenants, and modify loan agreements if necessary.

Changes to lease accounting

- The new lease accounting standard is effective for most private companies in 2022. Therefore, it's important to take inventory of all leasing activity, including related party and third-party leases.
- To track lease activity across an entire enterprise, Helmuth suggested using leasing software to help monitor active leases and accounting entries and track payments. Also, members of the group should consider developing and documenting accounting policy elections and evaluating the impact of related party leases (including short-term or month-to-month lease arrangements).

Read more:

- Understanding the new lease guidance
- New lease accounting: Top 10 FAQs surrounding ASC 842

Market considerations

- The conversation quickly shifted to concerns around the economy and when the impacts of inflation and rising interest rates may hit the construction industry.
- With rising inflation and a tepid labor force coming off the heels of the COVID-19 pandemic, many construction CFOs are facing scheduling conflicts resulting from labor shortages and wild price adjustments as material costs rise due to the downward market. With these headwinds, many senior leaders in the construction industry are looking for steps to minimize damage as they prepare to weather what they expect to be a bear market.
- As the Federal Reserve carries out the largest interest rate hike since 1994, many CFOs in the construction industry expect a sharp decline in building — major players like Amazon are halting construction. COVID-19 played a large part in disrupting the economy, as many industries experienced supply shortages that have resulted in large backlogs that provided a nice boom cycle post pandemic. However, with material costs again increasing, some CFOs are seeing projects put on pause.
- One CFO wondered about approaches to protect their business against unpredictable material pricing. Other participants stressed the importance of proof of financing with contingencies as well as escalator clauses.

Subcontractor concerns

- With labor challenges continuing to threaten delays, one CFO's company found they were able to alleviate some of their subcontracting needs through the acquisition of another contractor. Similarly, another CFO shared that they were able to expand into another locale through a horizontal acquisition. Echoing comments around expanding to other regions, another CFO stated they will always follow the customer and noted the industry has become more focused on strategic, customer-oriented location scouting.
- As the construction industry prepares to head into an economic slowdown, a major concern is whether or not subcontractors are able to deliver on their end. Determining this can be a challenge — as one CFO pointed out, financial statements are often outdated or inaccurate due to the sophistication of smaller subcontractors and make poor barometers for making forward-looking decisions in the current climate. The CFO wondered if there were other metrics that could be used to compare subcontractors against each other. While contractor scores exist, one CFO noted the best metric they found was a physical check-in — dropping in and getting a look at an operation up close can tell you much more than financial statements.

Subcontractor concerns

- When reviewing financial statements of subcontractors, there can also be questions around PPP loans and whether those could be inflating some financial numbers. Wipfli's Bill Hughes advised the group to proceed and underwrite PPP loans against performance, but it just shouldn't be the full amount of the PPP loan because without the money they received from the federal government, subs would have made other choices.

- One CFO shared experience from their time at a general contracting firm: They were able to establish a subcontractor qualification program that required a third-party review and would in return provide discounts for qualifications.

Inflationary impacts

- The recent inflationary period is straining an already challenging job market. Just months prior, many companies experienced a national resignation as employees everywhere sought changes to the standard practices of business. With some companies paying extravagant starting wages for certain positions, many CFOs worry this economic slump could push employees to look elsewhere for employment. One participant's company held their annual salary adjustment early this year in response to the turning economy but, despite implementing their largest increase in 20 years, are still experiencing problems with retention.

- As certain back-office positions continue to be poached by other companies, one CFO's organization went through and rightsized their administrative staff in order to protect those essential to the business.

- The current climate has some CFOs worried that younger talent may move away from the industry. As a result, leaders have started prioritizing higher increases for some of their newer talent, banking on the assumption that some of their senior staff members will continue with their employment based on the company culture.


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