New accounting standard for leases will affect the construction industry

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On May 16th, the Financial Accounting Standards Board (FASB) issued an exposure draft on proposed changes to accounting standards regarding leases (Topic 842).

These new standards will change the way leases are reported on company financial statements. Currently, Generally Accepted Accounting Principles (GAAP) require companies to recognize capital leases as both an asset and a liability in balance sheets, while operating lease payments only affect current operating income. Future leasing liabilities are disclosed only in the footnotes of the financial statements.

This approach has been criticized by many financial statement users because it does not meet their needs by not providing a clear picture of the future liabilities associated with these leases. The reason being, by including future liabilities as only a footnote, it is therefore presented as an "off-balance sheet."

The proposed change will require lessees to recognize both an asset and a liability in the balance sheet, similar to the current presentation of capital leases, for operating leases with a term longer than twelve months. This change will affect most industries but is especially significant for the construction industry as it will greatly influence how lenders and bonding agents view the financial health of a company.

At first glance, it may not appear to be a big deal because it seems all that is required to comply is for the company to record an asset and a liability in the same amount. It appears to net out to zero; therefore, one would expect that it should not really have much of an impact on the financial statements.

However, for companies with significant equipment and/or real property leases, this change will probably have the biggest impact on the computation of working capital (current assets less current liabilities). Since many loan covenants contain minimum working capital requirements under the new rules, the current liability for lease payments could cause a company to be non-compliant with those requirements.

Debt to equity and debt service ratios will also be greatly affected by these changes. As the company's debt will be increasing by the current value of all the future lease payments, a debt to equity ratio that used to be in compliance can easily become negative. Debt service costs will also be increasing due to the computed interest component of the lease payments that will now be included in interest expense. The aforementioned factors are also used in calculating a company's bonding capacity and therefore can have an adverse effect on the size of jobs that a company can bid on.

While the implementation date of these new standards has not been set, it is important that business owners and their financial professionals become aware of these changes now.

One of the biggest challenges will be educating banking professionals and bonding agents about these new requirements and preparing them for the changes well in advance of implementation. Loan agreements may have to be renegotiated or waivers granted so companies do not fall into default because of this change.

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