

# How the New Lease Accounting Standard Will Affect Construction Contractors

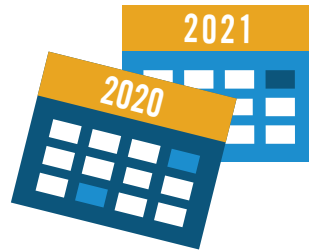
### WHAT

FASB Accounting Standards Update 2016-02, *Leases*, requires every entity with leased assets to record virtually every lease on the balance sheet as a right-of-use asset and a corresponding lease liability.



### WHEN

Beginning with fiscal years that start after December 15, 2021 (calendar year 2022), for nonpublic entities that follow U.S. Generally Accepted Accounting Principles (GAAP).



## WHY LEASE ACCOUNTING MATTERS

- Construction contractors often rely on leasing as a source of financing for specialized equipment and vehicles. Leasing provides access to these much-needed and expensive assets without the immediate cash flow hit that comes from an outright purchase.
- Under prior rules, operating leases were reported only in the note disclosures in the financial statements. By moving nearly all leases onto the face of the balance sheet, the new standard aims to increase transparency and make financial statements better reflect companies' financial positions.
- Upon recognition, the addition of a significant lease liability may skew financial covenants and even push loans out of compliance and impair working capital, thus affecting bonding capacity.
- Lessees will need to enhance processes to collect required lease information, such as original lease copies and supporting documents. Some of that information may currently be nonexistent or outdated, potentially requiring new IT systems and even dedicated personnel to track, administer, and account for lease activity.
- For entities with significant leasing activity, adoption of this standard will require significant time and human resources.



## HOW TO GET STARTED

**Take inventory.** All existing leases — from dump trucks to cranes to construction management software — will have to be evaluated to determine what accounting treatment is required under the new standard.

**Gather documentation.** Confirm the availability and location of all lease agreements, including master lease agreements and “evergreen” leases that may have rolled forward for many years, and verify that lease documentation is complete. If not locally available, procure copies of documents from owners of leased assets. Keep clear records of all lease-related activity together, so that documentation is readily available.

**Determine the accounting treatment for each lease.** For construction contractors with significant leasing activity, the time and expense to parse through each lease individually could be even greater than the cost of noncompliance. Ask your auditor to share a tool or template that will let you assess the proper accounting treatment for each lease and efficiently record entries on your financial statements.

**Consider practical expedients.** The FASB has offered a number of practical expedients to ease compliance, such as combining lease and nonlease components of the total payment and making an election to exempt short-term leases (those with terms of 12 months or less).

**Prepare for new disclosures.** The standard introduces quite a few new and expanded disclosures, many of which require new estimates. Perform a gap analysis to determine (1) what information you will need to start tracking, and (2) what types of adjustments to systems and processes will be required to generate the data.

**Review debt covenants.** Consider how debt-to-equity, additional indebtedness, other debt-based ratios, and limits on capital expenditures could be affected by the recognition of new operating lease liabilities. Consider preparing pro forma financial statements for 2021 and 2022 to project how covenants will be affected by the new standard.

**Communicate.** Talk to investors, lenders, sureties, and other stakeholders about expected changes in financial statements as soon as possible. For construction contractors that rely on loans for working capital or long-term needs, it is imperative to bring this issue to the attention of your banker and surety agent. Don't wait for them to bring this matter to you.

**Manage resources.** Plan for additional time and personnel to adequately implement new processes and procedures, gather and review data, create and monitor systems, and manage the individuals responsible for all these tasks. Assess in-house expertise and consider hiring additional accounting staff, software experts, or other consultants versed in the new rules.



**Consider the following steps to prepare for compliance.**

## CONSULT A PROFESSIONAL

Properly accounting for and managing leased assets is an important part of maintaining the health of your business.

To discuss steps you should be taking to prepare for the impact of the new lease accounting standard, consult CRI's construction accounting professionals.



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