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New Lease Standard and Impact on the Construction Industry

AUDIT, CONSTRUCTION, REAL ESTATE
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On February 25, 2016, the Financial Accounting Standards Board (FASB) issued its new lease accounting standard, *FASB Accounting Standard Update 2016-02 – Leases*. The new standard introduces a right-of-use model which brings most leases onto a lessee's balance sheet. This could significantly change the accounting for leases involving real estate, equipment and fleet, whose leases aren't typically included on the balance sheet because they are usually classified as operating leases under current United States Generally Accepted Accounting Principles (U.S. GAAP). The new standard retains much of the current lessor accounting model, and lessors should expect very little change in accounting.

ACCOUNTING STANDARD UPDATE 2016-02 – LEASES

Given the significant changes the new standard has on lessee accounting, contractors who currently have a significant amount of operating leases should consider the impact that the new standard will have on their financial statements including the following:

- **Increased Balance Sheet Leverage** – This standard will result in increased leverage on the lessee's balance sheet; therefore, contractors need to take this into consideration when talking to bonding companies and going through a prequalification process to perform various federal, state and local government contracts.
- **Impact on Balance Sheet Ratios** - Since the new standard will affect balance sheet leverage, balance sheet metrics and loan covenants could be negatively impacted. Contractors that are on the lessee side of lease agreements should consider whether the impact of adopting the new standard could trigger debt covenant violations.
- **Non-lease Components** – The new standard gives the lessee the option to make an accounting policy election to account for non-lease components (common area maintenance charges, real estate taxes or equipment service and maintenance charges) as part of the lease payments. This option can simplify the accounting and make the implementation process much more efficient. However, if this option is elected it could substantially increase the lease liability recognized on the balance sheet.
- **Potential Changes in Leasing Process** – This standard may complicate contractor's approval of new leases or lease modifications, since contractors may need to pay more attention to the effects on their financial statements. Under current U.S. GAAP, a contractor's decision to enter into an operating lease may not receive much opposition. Going forward, operating leases could be scrutinized as much as a purchase because of their effect on the balance sheet.

Overall, this new standard may have a significant impact on contractor's balance sheets and related financial statements. Contractors still have time to consider the impact that this standard will have on their financial statements, but should begin assessing what that impact may be and start discussing the impact with their financial statement users. The new guidance is effective for public entities for fiscal years beginning after December 15, 2018 and for fiscal years beginning after December 15, 2019 for all other entities.

We invite you to [download a copy of our free whitepaper which discusses the new lease standard in more detail](#), and also encourage you to [contact your Schneider Downs representative](#) if you would like more information, or feel an individual discussion would be beneficial.

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