Proposed accounting rule could have unintended consequences for construction companies

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The Financial Accounting Standards Board (FASB) held a meeting on July 11, 2017, to discuss a proposed debt classification rule that is far-reaching and may have unintended consequences on bidding requirements for construction contractors.

Accounting rules classify debt as current or long-term to enable lenders to assess lending risk and the borrower's financial health, based on their ability to meet current and future obligations. Presently, accounting rules for classifying debt include specific rules for a narrow set of fact patterns. By replacing these specialized rules with an overarching principle, the FASB's proposed rules would simplify debt classification rules for public and private companies alike.

The new principle would classify debt based on a company's contractual rights as of the balance sheet date, even if debt is refinanced prior to the date financial statements are issued. In order to qualify as noncurrent debt under the proposed rule, the debt must satisfy one of the following:

- The debt must be settled 12 months or more after the balance sheet date.
- The organization must have a contractual right to defer settlement of the debt for at least 12 months after the balance sheet date

Public companies have generally praised the move due to benefits that reduce the cost and complexity of financial reporting. And with public company support, the FASB is expected to finalize these rules in a move towards simplification.

For construction contractors, though, the new rules could reduce the size of projects that they may bid on. Laws that regulate contractor bidding processes generally limit eligible contractors based upon their working capital as of the date their financial statements are issued. To improve their financial condition, then, contractors often renegotiate debt after the balance sheet date but before their financial statements are issued.

The proposed rules, on the other hand, would classify debt based upon contractors' contractual rights existing as of the balance sheet date. Due to this rule change, among others, the proposed rules would likely designate long-term debt as current debt, thereby increasing contractors' current liabilities and significantly reducing their working capital. The reduced working capital in turn may cut contractors out of the bidding process where they do not meet eligibility standards. Conceivably, statutes and regulations may be rewritten to account for the new accounting rules, but such law changes are uncertain and could take years to enact.

For more information on the FASB rules and how they may affect construction contractors and the bidding process, please contact a member of the McDonald Hopkins construction or tax team, or one of the specific attorneys listed below.

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