Comments on Proposed Accounting Standards Update—Leases (Topic 842): Targeted Improvements

Submitted By: Financial Statement Analysis Course Participants at American University

Dear Director of FASB,

Below are some remarks and comments by my graduate students in my Financial Statement Analysis course at American university regarding the Proposed Accounting Standards Update—Leases (Topic 842): Targeted Improvements:

The new standards give us more forward looking projections of the long-term debt obligations of corporate leases. This gives us a better idea of future expenditures and equity valuation. Forcing operating leases into the balance sheet, big companies like Walgreens, AT&T, CVS, Walmart and McDonalds might surprise their stakeholders when they see all of these "new" liabilities on their financial statements, but we support the idea of fully disclosing information with your stakeholders. We don't think that companies should be trying to hide leases in the notes of financial statements in order to gain some sort of benefit or receive a higher valuation.

If an analyst is trying to determine a realistic valuation for a company that has lots of leasing activity, then this proposal will likely make that job much easier. However, we do wonder about companies delaying their deadline to entry intentionally. They may be "dragging their feet" so that the market is desensitized to the new regulation by the time they finally do enter. However, some firms that have been accounting for leases as an operating expense have been fully disclosing their activity. While the lease activity is not reflected in their balance sheets, analysts still have adequate information on the leasing activity to forecast financials accurately. If these same firms utilize straight-line depreciation the changes will have minimal effects on net income and earnings. These leasing activities represent off-balance sheet financing of assets, where the leased assets and associated liabilities of future payments are not captured on the balance sheet of a company. For these firms, we don't believe the change in reporting requirements will be significant on their income statements. The impact from this change will be most noticeable in their balance sheet ratios. Our concern is the potential for analysts to skew analysis of business activity if historical trends are not adjusted (proforma) to account for these changes.

Firms should be required to disclose prior year and prior period financial metrics with the new format applied to give context. In short, the impact depends on the firm, their business model and the industry in which they operate; overall will make financial analysis among peer groups much easier which we think is incredibly beneficial. By requiring all firms to treat all leasing and asset purchases in a similar manner it eliminates any possible ambiguity about the financial position of a company, regardless of the business model. Still, we anticipate this change will impact some companies and industries more heavily than others.

By updating the regulations on financial reporting to include lease agreements it allows a better valuation of companies. We think the Financial Accounting Standards Board should set clearer deadlines for when each business needs to put this into practice. Also, instead of having two deadlines, they should have made a universal deadline where each business will need to convert to the new reporting method. This will ultimately cause some chaos in the market, when companies make the switch.

This leads to another concern of what will be done with past records. Will all accounting records need to be updated in order to meet this standard and how will this affect the valuation models of firms today? When investors are made aware of these substantial changes, which impact stockholder equity, will this cause a dramatic correction in current market value.
The phasing in of the new standard is problematic and in the interim, until the required deadline, should carry a clear standardized language requirement to indicate if a company has come into compliance with the new directive or not yet and once the deadline has passed, indicate for the following three years, the reporting period in which the firm adopted the standard to create transparency for year over year comparison.

This new standard is good for comparability across different firms and industry and provides further insight into the financial status of the lessee. The Change eliminates a large source of off balance sheet financing.

Sincerely,

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