Guideline Rent Expense Multiples for Use with Moody’s Global Standard Adjustment to Capitalize Operating Leases

Summary

In this report, we summarize by industry the multiples of rent expense that Moody’s uses in connection with its Global Standard Adjustment to capitalize leases that companies account for as operating leases. The adjustment to capitalize operating leases is one of nine standard analytic adjustments embodied in companion methodologies that describe Moody’s standard analytic adjustments to the financial statements of non-financial corporations that report under US or Canadian GAAP1 and International Financial Reporting Standards2.

For consistency, we will generally use the same multiple for companies by sector of activity (Table 2). We present these multiples to provide transparency regarding the inputs used to calculate the standard adjustment to capitalize leases for companies in different industries. The lease multiples contained in this document are intended to serve as general guidance and are not intended to override consideration of an individual issuer’s circumstances. To the extent that facts and circumstances strongly warrant, the multiple of rent expense used to capitalize operating leases for an individual issuer may differ from the multiple generally used for that issuer’s industry though we would expect exceptions to be rare. Nonetheless, in no event, will we capitalize operating lease commitments at less than the present value of the future lease payments (discounted by the long-term borrowing rate).

The Standard Adjustment For Operating Leases

THE REPORTING PROBLEM

Accounting standards distinguish between capital and operating leases, and the accounting for the two is very different. Accounting standards view capital leases as the acquisition of a long-term property right and the incurrence of debt. During the lease term, companies amortize the capitalized property right and divide the lease payment between interest expense and the repayment of debt. In contrast, accounting standards view operating leases as executory (off-balance sheet) contracts that are generally accounted for on a pay-as-you-go basis. That is, companies simply recognize the lease payments as lease expense on the income statement and as an operating cash outflow on the cash flow statement.

For operating leases, companies don’t recognize debt even though they are contractually obligated for lease payments and a failure to make a lease payment often triggers events of default, as if the obligation were debt. Further, in the eyes of lenders, incurring operating lease obligations reduces a company’s borrowing capacity. Finally, in the absence of a lease financing option, the company would likely borrow the money and buy the asset; an illustration of this fact can be seen in the number of companies across industries that are selling and leasing back the same assets.

Further, accounting standards distinguish between capital and operating leases using arbitrary bright line tests. As a result, companies structure transactions to achieve certain accounting, and, at the margin, the economic distinction between capital and operating leases is insignificant even though the accounting is very different. This results in lack of comparability between companies that account for similar economic transactions differently and between companies that lease assets versus those that buy them.

**MOODY’S ANALYTICAL RESPONSE**

Our analytic goal is to simulate a company’s financial statements assuming it had bought and depreciated the leased assets, and financed the purchase with a like amount of debt. Moody’s approach entails adjustments to the balance sheet, income and cash flow statements.

We will apply a multiple to current rent expense to calculate the amount of the adjustment to debt. This methodology has been used in the past, as many analysts applied an 8x rent factor to assess a company’s effective leverage. The 8x rent factor, while providing a quick thumbnail estimate, assumes a certain interest rate (6%) on a piece of capital equipment with a long useful life (15 years), and is not appropriate for all lease types. To accommodate a wider array of useful lives and interest rates, we have expanded the number of rent factors to 5x, 6x, 8x and 10x. For consistency, we will generally use the same multiple for companies by sector of activity. But in no event will we capitalize operating leases at less than the present value of the future lease payments (discounted by the long-term borrowing rate).

**HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS**

Table 1 below describes Moody’s adjustments to capitalize operating leases.

<table>
<thead>
<tr>
<th><strong>Table 1: Standard Adjustments for Operating Leases</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td>We adjust the balance sheet by adding both debt and fixed assets (usually gross plant, property and equipment). We compute this debt by multiplying current rent expense by a factor of 5X, 6X, 8X or 10X, or, if the present value (PV) of the minimum lease commitments (using the incremental borrowing rate as the discount rate) is higher, we use the PV.</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td>We adjust the income statement to reclassify one-third of the rent expense to interest expense and the remaining two-thirds to &quot;Depreciation - Capitalized Operating Leases&quot; (a component of operating profit), and we adjust operating expenses (or cost of goods sold and selling, general &amp; administrative expenses) proportionally.</td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
</tr>
<tr>
<td>We adjust the cash flow statement to reclassify the principal portion of lease payments from operating cash flow (CFO) to a financing cash outflow (CFF). We also simulate capital expenditure for newly acquired leased assets by increasing the capital expenditures line in investing cash flows (CFI) with a concomitant borrowing in CFF to fund the capital expenditures.</td>
</tr>
</tbody>
</table>

**Lease Multiples For Industry Peer Groups**

Table 2 below depicts the multiple of rent expense used by Moody’s analysts to capitalize operating leases for companies operating within the following 46 broad industries. These multiples have been arrived at through a wide consultation within Moody’s global analytical teams by taking into account the particularities of each sector and the type and mix of assets that are typically leased in each industry. To the extent that sub-sectors need to be identified within these broad categories, we will on a case by case basis establish new guidelines for such sub-sectors.
<table>
<thead>
<tr>
<th>Industry</th>
<th>Multiple of Rent Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace / Defense</td>
<td>6</td>
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<tr>
<td>Automotive</td>
<td>6</td>
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<tr>
<td>Chemicals</td>
<td>6</td>
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<tr>
<td>Consumer Products</td>
<td>6</td>
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<tr>
<td>Energy: Electricity Cooperative</td>
<td>6</td>
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<tr>
<td>Energy: Electricity - Project Finance</td>
<td>6</td>
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<tr>
<td>Energy: Electricity - Non Project Finance</td>
<td>8</td>
</tr>
<tr>
<td>Energy: Oil &amp; Gas - Drilling</td>
<td>5</td>
</tr>
<tr>
<td>Energy: Oil &amp; Gas - Exploration &amp; Production</td>
<td>6</td>
</tr>
<tr>
<td>Energy: Oil &amp; Gas - Integrated</td>
<td>6</td>
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<tr>
<td>Energy: Oil &amp; Gas - Merchant Energy</td>
<td>6</td>
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<tr>
<td>Energy: Oil &amp; Gas - Midstream</td>
<td>6</td>
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<tr>
<td>Energy: Oil &amp; Gas - Project Finance</td>
<td>6</td>
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<tr>
<td>Energy: Oil &amp; Gas - Refining &amp; Marketing</td>
<td>6</td>
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<tr>
<td>Energy: Oil &amp; Gas - Services</td>
<td>5</td>
</tr>
<tr>
<td>Environment</td>
<td>6</td>
</tr>
<tr>
<td>Forest Products</td>
<td>5</td>
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<tr>
<td>Gaming / Lodging</td>
<td>8</td>
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<tr>
<td>Healthcare - Hospitals and Services</td>
<td>6</td>
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<tr>
<td>Healthcare - Medical Devices</td>
<td>6</td>
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<tr>
<td>Homebuilding</td>
<td>5</td>
</tr>
<tr>
<td>Leisure &amp; Entertainment</td>
<td>8</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>6</td>
</tr>
<tr>
<td>Media: Advertising &amp; Broadcasting</td>
<td>6</td>
</tr>
<tr>
<td>Media: Diversified, Paid TV &amp; Subscription Radio</td>
<td>6</td>
</tr>
<tr>
<td>Media: Printing &amp; Publishing</td>
<td>6</td>
</tr>
<tr>
<td>Metals &amp; Mining</td>
<td>5</td>
</tr>
<tr>
<td>Natural Products Processor</td>
<td>6</td>
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<tr>
<td>Packaging</td>
<td>5</td>
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<tr>
<td>Pharmaceuticals</td>
<td>5</td>
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<tr>
<td>Public Utility</td>
<td>6</td>
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<tr>
<td>Public Utility - Gas Distribution</td>
<td>8</td>
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<tr>
<td>Public Utility - Gas Transmission</td>
<td>8</td>
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<tr>
<td>Restaurants</td>
<td>8</td>
</tr>
<tr>
<td>Retail</td>
<td>8</td>
</tr>
<tr>
<td>Services - Business</td>
<td>6</td>
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<tr>
<td>Services - Consumer</td>
<td>6</td>
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<tr>
<td>Services - Contractors</td>
<td>5</td>
</tr>
<tr>
<td>Services - Processors</td>
<td>5</td>
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<tr>
<td>Services - Rental</td>
<td>5</td>
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<tr>
<td>Services - Towers &amp; Satellites</td>
<td>5</td>
</tr>
<tr>
<td>Technology</td>
<td>5</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>5</td>
</tr>
<tr>
<td>Transportation Services</td>
<td>6</td>
</tr>
<tr>
<td>Airline</td>
<td>8</td>
</tr>
<tr>
<td>Maritime Shipping</td>
<td>8</td>
</tr>
<tr>
<td>Transportation Services - Airports &amp; Toll Roads</td>
<td>6</td>
</tr>
<tr>
<td>Wholesale Distribution</td>
<td>6</td>
</tr>
</tbody>
</table>
Appendix A

Table 2 on page 3 of this report has been updated to include multiples of rent expense for the Airline and Maritime Shipping industries.
Moody’s Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part I

Standardized Adjustments to Enable Global Consistency for US and Canadian GAAP Issuers

Product of the Global Standards Committee

In this Methodology we announce changes to the global standard adjustments to financial statements of non-financial corporations that report under US or Canadian GAAP and reissue the complete methodology, updated for changes, so that we continue to summarize in a single document the most recent status of our global standard adjustments. A companion document discusses adjustments to financial statements prepared under International Financial Reporting Standards (IFRS) 2.

This methodology is the product of the Global Standards Committee, which is responsible for defining the standards that Moody’s corporate analysts employ in analyzing financial statements. Our goal in doing so is to enhance consistency of our global rating practice, among analysts, and across countries and industries.

Changes to our Global Standard Adjustments

We are changing our adjustments related to pension plans and operating leases, representing two of our nine standard adjustments.

PENSIONS

We are adding an incremental adjustment related to “unfunded” defined benefit pension plans. With unfunded plans, common in certain European countries, companies are not required and elect not to set aside assets in a separate pension trust. Moody’s has long adjusted financial statements of European companies sponsoring these plans 3, as described below. By extending this adjustment to companies that report under US or Canadian GAAP, we are standardizing our analysis of unfunded plans for all companies, no matter where their locations or the GAAP of their home countries.

3. See Moody's Approach to Analyzing Pension Obligations of Corporations, November 1998 (#39330)
Unfunded and pre-funded pension systems differ in important respects. In contrast to pre-funded systems, unfunded systems:

- Result in the inclusion of the gross pension obligation (in place of the net obligation) on the balance sheet;
- Usually do not require pre-funding of the pension obligation; and
- Allow a long time horizon to deal with funding of pension payments providing sponsoring companies with a choice of how to meet their obligations.

To improve accounting comparability with pre-funded plans, Moody’s incremental adjustment for unfunded plans simulates pre-funding of the gross pension obligation. If the company sponsoring the unfunded plan can access the capital markets, Moody’s assumes that the company will maintain its existing debt and equity mix in funding future pension obligations. As a result, for unfunded pensions, we adjust the sponsoring company’s balance sheet for an “equity credit,” which reduces the amount of gross pension obligation that we would otherwise reclassify to debt.

Moody’s does not further adjust the income statement or the cash flow statement for companies with unfunded pension obligations, other than to align interest expense with our adjustment to debt for the “equity credit” noted above.

We provide the specific mechanics of our unfunded pension adjustment in this methodology under Part 2 of the pension adjustment (Adjustment #1).

Our adjustment for unfunded pensions will reduce the amount of adjusted debt for some global companies sponsoring unfunded pension plans. However, we suspect that this adjustment will impact the ratings of few, if any, companies.

**OPERATING LEASES**

We are changing two features of our adjustment to capitalize leases that companies account for as operating leases in order to:

1. Simplify the calculations of lease-related debt and the interest and depreciation components of rent expense
2. Increase the amount of capital expenditures companies report on the cash flow statement by the depreciation component of rent expense. Our former lease adjustment did not affect capital expenditures.

Since the announcement of standard adjustments in July 2005 companies and investors have argued that our lease adjustments were unnecessarily complex. We believe we can simplify the calculation, while meeting our goal of improving comparability between firms which purchase and firms which lease assets.

In place of the modified present value method, we will calculate the amount of debt related to operating leases based on a multiple of the most recent year’s rent expense generally standardized by industry. We are also simplifying our calculations of the interest and depreciation components of rent expense based on market convention that interest is one-third of lease expense and depreciation the remaining two thirds. While more complex calculations produce a slightly more accurate result, the simple market convention produces a result that is sufficiently accurate.

We are also amending our adjustment for operating leases to increase the amount of capital expenditures companies report on the cash flow statement to reflect the spending needed to support the business. We based our former approach, which did not affect capital expenditures, on how accounting rules report capital leases, viewing them as non-cash transactions at inception of the lease. Although consistent with accounting rules, not recognizing capital expenditures for leases understates the amount of capital assets and spending needed to support the business. This, in turn, overstates certain credit-relevant metrics, such as free cash flow. As a rough approximation of capital expenditures related to leasing, we will assume that operating leases increase capital expenditures by the amount of depreciation we attribute to the leased assets.

Our modeling suggests that our simplified approach to the operating lease adjustment closely approximates the results we would achieve using our more complex approach. Accordingly, we expect our simplified approach will not impact our credit ratings.

The remainder of this document presents our methodology for all standard adjustments for companies’ financial statements, updated for the changes we outlined above.

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4. If the multiple approach results in lease-related debt that is less than the present value of future minimum lease payments, we will use the present value amount as a floor.
Summary

Moody's adjusts financial statements to better reflect the underlying economics of transactions and events and to improve the comparability of financial statements. We compute credit-relevant ratios using adjusted data and base our debt ratings, in part, on those ratios.

This report, the first of a two part series, discusses Moody’s Standard Adjustments to financial statements prepared under US and Canadian accounting principles (GAAP). Part II discusses our standard adjustments to statements following International Financial Reporting Standards (IFRS). Those adjustments include many we discuss herein and a few that are unique to IFRS.

The standard adjustments Moody's applies to financial statements following US and Canadian GAAP relate to:

- Underfunded and unfunded defined benefit pensions
- Operating leases
- Capitalized interest
- Employee stock compensation
- Hybrid securities
- Securitizations
- Inventory on a LIFO cost basis
- Unusual and non-recurring items

Analysts compute Standard Adjustments with the help of worksheets, which promote consistency and accuracy (see the Appendix for Worksheets A through I). Moody's has published methodologies relating to several of the adjustments and the worksheet calculations have been prepared in accordance with these methodologies. Two methodologies pertaining to unfunded defined benefit pensions and operating leases are modified by this report and the changes are discussed herein.

In addition to the Standard Adjustments, Moody's analysts may also make non-standard adjustments to financial statements for other matters to better reflect underlying economics and improve comparability with peer companies. For example, we may adjust financial statements to reflect estimates or assumptions that we believe are more prudent for credit analysis.

With the introduction of Standard Adjustments, Moody's research will, over time disclose, for each rated company, the nature and amount of all Standard Adjustments and those other adjustments that we make based on publicly available information. We will also publish key financial ratios reflecting the adjustments we make to financial statements. Our financial ratios will no longer contain complicated add backs to the numerators and denominators, but will instead be simpler constructs based on fully adjusted sets of financial statements.

Our adjustments do not imply that a company's financial statements fail to comply with GAAP. Indeed, many of our adjustments are inconsistent with current accounting principles. Our goal is to enhance the analytical value of financial data and not to measure compliance with rules.

Over time, we may modify our Standard Adjustments as global reporting issues evolve. If so, we will alert readers of our research and, where appropriate, solicit comment prior to doing so.

Adjustments — Purpose, Methods and Transparency

In general, Moody's adjusts financial statements to better reflect, for analytical purposes, the underlying economics of transactions and events and to improve comparability of a company's financial statements with those of its peers. More specifically, we adjust financial statements to:

- **Apply accounting principles that we believe more faithfully capture underlying economics.** One example is our view that operating leases create property rights and debt-like obligations that we should recognize on balance sheets. Indeed, most of our standard adjustments fall in the accounting principle category.
- **Identify and segregate the effects of unusual or non-recurring items.** By stripping out these effects, we are better able to perceive the results of ongoing, recurring and sustainable activities. Our standard adjustment “unusual and non-recurring items” addresses this category.
- **Improve comparability by aligning accounting principles.** For example, we adjust LIFO inventories so that all companies in a peer group measure inventory on a comparable, in this case FIFO, basis.
- **Reflect estimates or assumptions that we believe are more prudent, for analytical purposes, in the company's particular circumstances.** These adjustments typically relate to highly judgmental areas such as asset
valuation allowances, impairment of assets, and contingent liabilities. No standard adjustment falls in this
category as the calculations are too company-specific. Instead, we adjust financials in this area based on
individual facts and circumstances.

Our adjustments do not imply that a company’s financial statements fail to comply with GAAP. Indeed, many of
our adjustments are inconsistent with current accounting principles. Our goal is to enhance the analytical value of
financial data and not to measure compliance with rules.

Moody’s has long adjusted financial data to improve analytical insight. The purpose and concepts of adjustments
are not new and Moody’s has published several methodologies that discuss analytic adjustments. However, concurrent
with this rating methodology, Moody’s is now formalizing and standardizing certain adjustments. Our goal in doing so
is to enhance consistency of our global rating practice, among analysts, and across countries and industries.

We are facilitating the calculation of Standard Adjustments with worksheets (see Appendix for Worksheets A
though I). Standard Adjustments supported by worksheets enable a disciplined and systematic method for analyzing
company financial data we use in the rating process. This, in turn, produces more comparable data for peer compari-
sions that are critical to our ratings. Moody’s has published methodologies relating to several of the Standard Adjust-
ments and the worksheet calculations have been prepared in accordance with these methodologies.

This report modifies two adjustments, those pertaining to unfunded defined benefit pensions and operating leases.
Details of the modifications are included in sections of this report entitled:

- Standard Adjustment # 1 — Underfunded and Unfunded Defined Benefit Pensions, and
- Standard Adjustment # 2 — Operating Leases.

We will publish key financial ratios reflecting the adjustments we make to financial statements. Concurrent with
this rating methodology, we are changing our practice of adjusting financial data through the definition of ratios.
Going forward, we will make comprehensive adjustments to complete sets of financial statements and then compute
ratios based on the adjusted financial statements. Our basic financial ratios will no longer contain complicated add
backs to the numerators and denominators, but will instead be simpler constructs based on fully adjusted sets of finan-
cial statements.

Our adjustments affect all three primary financial statements, which, after our adjustments, continue to interact:

- **Balance sheet**: We are adjusting the value of certain items, removing the artificial effects of smoothing per-
  missioned by accounting standards, recognizing certain off-balance sheet transactions, and changing the debt
  versus equity classification of certain hybrid financial instruments with both debt and equity features.

- **Income statement**: We are eliminating the effects of certain smoothing, recognizing additional expenses, attrib-
  uting interest to new debt that we recognize, and segregating the effects of unusual or non-recurring items.

- **Cash flow statement**: We are adjusting the cash flow statement to be consistent with our adjustments to the
  balance sheet and income statement. For example, we are identifying and segregating the cash effects of the
  unusual transactions and events that we separate on the income statement.

We will warehouse “unadjusted financials” (i.e. publicly reported financials) and “adjusted financials” (i.e. publicly
reported data plus adjustments) in a database and use it to generate peer comparisons and quantitative rating criteria by
industry. This data will facilitate rating comparability and more transparent communication.

Moody’s will be increasingly transparent to the market about the nature and amount of analytical adjustments we
are making to a company’s financial statements. With the introduction of Standard Adjustments, Moody’s research
will, over time, disclose, for each rated company, the nature and amount of all Standard Adjustments and those other
adjustments that the analyst bases on publicly available information. We will also publish key financial ratios reflecting
the adjustments we make to financial statements.
Adjustments — Nature

The following describes the Standard Adjustments applicable to US and Canadian GAAP financial statements and the name of related previously published methodology.

| Table 1: Standard Adjustments and Corresponding Methodologies |
| --- | --- | --- |
| Adjustment | Purpose | Methodology |
| Underfunded and unfunded defined benefit pensions | To eliminate the effects of artificial smoothing of pension expense permitted by accounting standards and recognize as debt, to the extent appropriate, the amount the pension obligation is under- or unfunded. We also change the classification of cash contributed to the pension trust on the cash flow statement under certain circumstances. | Moody's Approach to Analyzing Pension Obligations of Corporations, November 1996 (#39330) | Analytical Observations Related to US Pension Obligations, January 2003 (#77242) |
| Operating leases | To capitalize operating leases and recognize a related debt obligation. We re-characterize rent expense on the income statement by imputing interest on the debt (one-third of rent) and considering the residual amount (two-thirds of rent) depreciation. On the cash flow statement we reclassify the principal payment portion of the rent payment and simulate capital expenditures for newly acquired assets under operating leases. | Off-Balance Sheet Leases: Capitalization and Ratings Implications, October 1999 (#48591) |
| Capitalized interest | To expense the amount of interest capitalized in the current year. On the cash flow statement, we reclassify capitalized interest from an investing cash outflow to operating cash outflow. | *** |
| Employee stock compensation | To expense the cost of employee stock compensation for companies not recognizing this expense. On the cash flow statement, we classify the tax benefit from the exercise of stock options as a financing cash inflow. | Analytical Implications of Employee Stock-Based Compensation, December 2002 (#76392) |
| Inventory on a LIFO cost basis | To adjust inventory recorded on a LIFO cost basis to FIFO value. We do not adjust the income statement, believing that cost of goods sold on a LIFO basis is a superior method of matching current costs with revenues. | *** |
| Unusual and non-recurring items | To reclassify the effects of unusual or nonrecurring transactions and events to a separate category on the income and cash flow statements. Our analytical ratios that include income or operating cash flows generally exclude amounts in those separate categories. | *** |

***Moody's has not published Methodologies or Special comments on this adjustment.
In addition to the Standard Adjustments, Moody’s may also make non-standard adjustments to financial statements for other matters to better reflect underlying economics and improve comparability with peer companies. For example, analysts may adjust financial statements to reflect estimates or assumptions that they believe are more prudent for credit analysis.

In most cases we can compute our Standard Adjustments based on public information. In contrast, we compute non-standard adjustments using public or private information. Despite our goal of transparency related to adjustments, we are obviously restricted in what we are able to publish related to adjustments that we base on private information.

**Standard Adjustment #1: Defined Benefit Pensions**

There are two types of defined benefit pension schemes — “pre-funded” schemes where companies are required to set aside assets in a separate trust to fund future benefits and “unfunded” schemes where companies are not required and elect not to set aside assets in a separate trust. Part 1 of our discussion of this adjustment addresses both types of schemes. Part 2 addresses an incremental adjustment that is unique to unfunded plans. In circumstances where a company starts to voluntarily pre-fund a previously unfunded pension obligation, Moody’s will continue to treat the arrangement as unfunded until the plan assets amount to 75% of the PBO, or are expected to reach this level in the near future.

**THE REPORTING PROBLEM — PART 1**

Current accounting standards often fail to recognize or fully recognize on the sponsor’s balance sheet its economic obligation to its pension trust and employees because of extensive artificial smoothing mechanisms permitted in pension accounting. Artificial smoothing also distorts the measurement of pension expense. The smoothing mechanisms permit the deferral of large losses and gains, which can result in incongruous reporting such as:

- Recording pension income during a period when the economic status of the plan deteriorates, and
- Recording pension related assets on the balance sheet when the pension plan is underfunded

On the cash flow statement, standards require companies to classify cash contributions to the pension trust as an operating cash outflow in the cashflow statement, including the portion that is reducing plan underfunding, which arguably represents the reduction of debt. As a result, cash from operations (CFO) is diminished for a contribution to the trust that is more akin to a financing activity.

**MOODY’S ANALYTICAL RESPONSE — PART 1**

Moody’s believes that a sponsor’s balance sheet should reflect a liability equal to the underfunded status of the pension plan (except as noted in Part 2 below for unfunded schemes). We measure that liability at the balance sheet date as the excess of the actuarially determined projected benefit obligation (PBO) over the fair value of assets in the pension trust.

Because of the contractual nature of pension obligations, we view the pension liability as “debt - like”. Thus, we classify it as debt on the balance sheet and include it in the computation of ratios that use debt. We also record a related deferred tax asset which tempers the impact of our debt adjustment on equity. Because of the inherent uncertainty in the timing and amount of future tax deductions, it is Moody’s standard practice to present liabilities before any anticipated tax benefits.

On the income statement, our goal is to report pension expense absent the effects of artificial smoothing, such as the amortization of prior service cost and actuarial gains and losses. We view pension expense to equal the year’s service cost, plus interest on the gross pension obligation (PBO), minus actual earnings on plan assets. However, volatility in the performance of the pension plan assets is not reflected in EBIT because Moody’s excludes the caption “other non-recurring expense” from EBIT.

On the cash flow statement, we view cash contributions to the pension trust in excess of service cost as the repayment of (pension) debt.

**HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS — PART 1**

The following table describes Moody’s adjustments related to underfunded defined benefit pension obligations. Worksheet A in the Appendix provides the detail underlying the calculations.

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5. Some argue that a better measure of the pension obligation is the accumulated benefit obligation, or ABO. Unlike PBO, ABO does not assume future compensation increases for employers. Moody’s believes that PBO is the better measure for a company that is a going concern.

6. We limit the amount of gains on assets to the amount of interest to avoid recording pension income that is probably not sustainable. Also, in general, plan sponsors cannot utilize the gain on pension plan assets to satisfy non-pension related obligations and the monetization of plan assets may give rise to significant tax penalties.
The most critical assumptions in pension accounting often relate to the discount rate used to assess the present value of future payments and the assumed returns on pension assets. Where these assumptions appear unsustainable or significantly different than those of a company’s peers, we will often investigate the reasons why management chose those assumptions. The explanation may cause us to change our adjustment or provide other insight into credit risk. For example, if we conclude that the discount rate is aggressive, we may request that management calculate PBO using a lower rate and base our pension adjustment on that calculation. As another example, understanding the reason for a high expected rate of return on assets could provide us with insight into the nature and risk of the assets in the pension trust.

THE REPORTING PROBLEM — PART 2

For countries such as Germany and Austria with an unfunded pension system, there are a number of significant differences compared to pre-funded schemes. In particular unfunded pension arrangements:

- Result in the inclusion of the gross pension obligation (in place of the net obligation) on the balance sheet;
- Typically have no statutory requirement for cash pre-funding of the gross obligation; and
- Allow a long time horizon to deal with the actual funding of pension payments which provides the sponsoring companies with a choice of how to meet their obligations.

MOODY’S ANALYTIC RESPONSE — PART 2

For unfunded pension plans, Moody’s considers the PBO to be only partially “debt - like”. To improve comparability with pre-funded pensions, Moody’s simulates a pre-funding of pension obligations for companies that are not required to pre-fund. Given the long-term horizon for payment of pension obligations and the general predictability of the payment streams, the company will likely have time to secure the necessary financing. In cases where the company has the ability to easily access the capital markets, Moody’s assumes that management’s targeted debt and equity mix will be used to fund future pension obligations.

Consequently, for unfunded pensions, an additional adjustment is made to the balance sheet to incorporate an “equity credit” which reduces the amount of the gross pension obligation (PBO) that would otherwise be added to debt. However, excess liquid funds reduce the likelihood of additional equity being raised and the equity credit is therefore calculated after the excess liquid funds have been deducted from the PBO. Excess liquid funds are discretionary amounts of cash and marketable securities that exceed day-to-day needs for operations. For industrial companies, these day-to-day cash needs would typically be estimated at 3% of revenues, depending on the complexity of the company’s payment streams and the efficiency of its cash management systems.

Moody’s does not further adjust the income statement or the cash flow statement for companies with unfunded pension obligations, other than to align the interest expense with the adjustment to debt described in the previous paragraph. The remaining interest cost on the PBO is included in other non-recurring expense.

---

**Table 2: Standard Adjustments for Underfunded Defined Benefit Pensions**

| **Balance Sheet** | We adjust the balance sheet by recording as debt the amount by which the defined benefit pension obligation is unfunded or underfunded. Our adjustment:
|                  | • recognizes the unfunded or underfunded pension obligation (PBO - FMV of assets) as debt, and
|                  | • removes all other pension assets and liabilities recognized under GAAP. |
| **Income Statement** | We adjust pension expense to eliminate smoothing, and exclude net periodic pension income. Moody’s:
|                  | • reverses all pension costs;
|                  | • recognizes the service cost, which Moody’s considers the best estimate of the operating cost of the pension plan (in proportion to COGS, Operating Expenses and SG&A);
|                  | • recognizes interest cost on the PBO in other non-recurring income/expense;
|                  | • attributes interest expense to pension-related debt, which we reclassify from other non-recurring income/expense to interest expense;
|                  | • adds or subtracts actual losses or gains on pension assets (but only in an amount up to the interest cost after attributing interest expense to pension-related debt) in other non-recurring income/expense. |
| **Cash Flow Statement** | We adjust the cash flow statement to:
|                  | • recognize only the service cost as an outflow from cash from operations (CFO), and
|                  | • reclassify employer cash pension contributions in excess of the service cost from an operating cash outflow (CFO) to a financing cash outflow (CFF) |
|                  | • We do not adjust the cash flow statement if pension contributions are less than the service cost. |

---

7. Note that the assumed rate of return on pension assets is irrelevant to our pension-related adjustments.
HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS — PART 2

The following table describes Moody’s adjustment related to unfunded defined benefit pension obligations. Worksheet A in the Appendix provides the detail underlying the calculations.

<table>
<thead>
<tr>
<th>Table 2a: Standard Adjustments for Unfunded Defined Benefit Pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td>We adjust the balance sheet to record an “equity credit” that simulates funding of the company's unfunded PBO.</td>
</tr>
<tr>
<td>Our adjustment:</td>
</tr>
<tr>
<td>• reverses a portion of the debt recognized in Part 1 of our adjustment for defined benefit pension plans, and</td>
</tr>
<tr>
<td>• recognizes a corresponding increase in equity.</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td>We do not further adjust the income statement for unfunded pension plans, other than to align the interest expense with our adjustment to debt.</td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
</tr>
<tr>
<td>We do not further adjust the cash flow statement for unfunded pension plans.</td>
</tr>
</tbody>
</table>

Standard Adjustment #2: Operating Leases

THE REPORTING PROBLEM

Accounting standards distinguish between capital and operating leases, and the accounting for the two is very different. Accounting standards view capital leases as the acquisition of a long-term property right and the incurrence of debt. During the lease term, companies amortize the capitalized property right and divide the lease payment between interest expense and the repayment of debt. In contrast, accounting standards view operating leases as executory (off-balance sheet) contracts that are generally accounted for on a pay-as-you-go basis. That is, companies simply recognize the lease payments as lease expense on the income statement and as an operating cash outflow on the cash flow statement.

For operating leases, companies don’t recognize debt even though they are contractually obligated for lease payments and a failure to make a lease payment often triggers events of default, as if the obligation were debt. Further, in the eyes of lenders, incurring operating lease obligations reduces a company’s borrowing capacity. Finally, in the absence of a lease financing option, the company would likely borrow the money and buy the asset; an illustration of this fact can be seen in the number of companies across industries that are selling and leasing back the same assets.

Further, accounting standards distinguish between capital and operating leases using arbitrary bright line tests. As a result, companies structure transactions to achieve certain accounting, and, at the margin, the economic distinction between capital and operating leases is insignificant even though the accounting is very different. This results in non-comparability between companies that account for similar economic transactions differently and between companies that lease assets versus those that buy them.

MOODY’S ANALYTICAL RESPONSE

Our analytic goal is to simulate a company’s financial statements assuming it had bought and depreciated the leased assets, and financed the purchase with a like amount of debt. Moody’s approach entails adjustments to the balance sheet, income and cash flow statements.

We will apply a multiple to current rent expense to calculate the amount of the adjustment to debt. This methodology has been used in the past, as many analysts applied an 8x rent factor to assess a company’s effective leverage. The 8x rent factor, while providing a quick thumbainl estimate, assumes a certain interest rate (6%) on a piece of capital equipment with a long useful life (15 years), and is not appropriate for all lease types. To accommodate a wider array of useful lives and interest rates, we have expanded the number of rent factors to 5x, 6x, 8x and 10x. For consistency, we will generally use the same multiple for companies by sector of activity. But in no event will we capitalize operating leases at less than the present value of the future lease payments (discounted by the long-term borrowing rate).

HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS

The following table describes Moody’s adjustments to capitalize operating leases. Worksheet B in the Appendix provides the detail underlying the calculations.
Standard Adjustment #3: Capitalized Interest

THE REPORTING PROBLEM

Analysts typically wish to separately analyze the operations of a business from the financing of that business. This separation enables a more accurate portrayal of business operations, which is often the primary source of cash to repay debt.

However, accounting standards sometimes commingle operating and financing activities. One prominent example is capitalized interest, where, under certain circumstances, GAAP requires that a company capitalize interest cost as a part of property, plant and equipment (PP&E). In the year a company capitalizes interest, reported capital assets, income and cash flow from operations are all increased relative to what would have been reported had the company expensed all interest.

MOODY’S ANALYTICAL RESPONSE

Moody’s views capitalized interest as a cost for obtaining financing (i.e. interest expense) and believes that analysis of interest coverage should expense when incurred all interest cost regardless of whether a company recognizes that cost as an expense on its income statement or as an asset on its balance sheet. This requires modification to the balance sheet, income and cash flow statements.

HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS

The following table describes Moody’s adjustments to expense interest capitalized. Worksheet C in the Appendix provides the detail underlying the calculations.

<table>
<thead>
<tr>
<th>Table 3: Standard Adjustments for Operating Leases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 4: Standard Adjustments for Capitalized Interest</th>
</tr>
</thead>
</table>
| **Balance Sheet** | We adjust the balance sheet to:  
• reduce PP&E by the amount of interest capitalized during the period *  
• adjust deferred taxes, and  
• reduce retained earnings by the after-tax cost of the additional interest expense recognized on the income statement. |
| **Income Statement** | We adjust the income statement to:  
• increase interest expense by the amount of capitalized interest during the current period, and  
• reduce applicable tax expense. |
| **Cash Flow Statement** | We adjust the cash flow statement to reclassify capitalized interest from capital expenditures, an investing cash outflow (CFI), to interest expense, an operating cash outflow (CFO). |

* While in concept we should adjust for the cumulative effect of interest capitalized in all prior periods, for practical reasons we focus on only interest capitalized during a year. Those reasons include the difficulty of the calculation and that the cumulative treatment would rarely, if ever, be material to our rating.
THE REPORTING PROBLEM
Most US companies do not yet expense employee stock options (ESOs), although many do so. New US GAAP rules (now delayed until January 1, 2006 for calendar reporters) will require all companies to expense ESOs, and will ultimately improve comparability. Until then, financial statements are not comparable, for two reasons. First, companies that fail to expense ESOs are not comparable to those that do. Second, companies that fail to expense ESOs are not comparable to companies that do not compensate their employees with ESOs.

Additionally, US companies, whether or not they expense ESO's on their income statement, receive a US tax deduction for the difference between the exercise price and the strike price upon exercise of ESO's and the effect is a reduction in taxes payable. Current accounting rules treat the reduction in the tax liability as an increase in cash flow from operations. However, the amount of the tax benefit can fluctuate materially depending on the company's stock price, option terms and employee preferences. Tax benefits may be non-sustainable, particularly when the company is under stress and its stock price declines.

MOODY'S ANALYTICAL RESPONSE
Moody's believes that employee stock options are a form of compensation that should be expensed for purposes of analysis. Additionally, despite the fact that accounting guidance treats the reduction in the tax benefits related to ESO's as an increase to operating cash flow in the cash flow statement, Moody's believes that the tax benefit from stock option exercises is best viewed as a financing cash inflow (CFF), since the tax benefit:

1. relates to the issuance of an equity instrument,
2. is often non-recurring and highly volatile since it fluctuates depending on the company's stock price, the terms of the options plan and employee behavior,
3. would be classified with the cash outflow for share repurchases made to avoid dilution from stock options, and
4. would likely disappear when the company is under stress and employees don't exercise stock options.

We will adjust financial statements through December 31, 2005 when new accounting rules take effect that will level the playing field among companies.

For purposes of this adjustment, Moody's relies upon footnote disclosures relating to the value of the options and related pro-forma disclosures.

HOW MOODY'S ADJUSTS THE FINANCIAL STATEMENTS
The following table describes Moody's adjustments to record the effects of employee stock compensation. Worksheet D in the Appendix provides the detail underlying the calculations.

<table>
<thead>
<tr>
<th>Table 5: Standard Adjustments for Employee Stock Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td><strong>We adjust the balance sheet as if the stock options had been recorded as an expense. Our adjustments:</strong></td>
</tr>
<tr>
<td>• reduce retained earnings by the amount of after-tax pro-forma stock compensation expense; and</td>
</tr>
<tr>
<td>• increase common stock as if stock had been issued; and</td>
</tr>
<tr>
<td>• reduce deferred tax liabilities due to the decrease in tax expense.</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td><strong>We adjust the income statement as if the company expensed stock options. Our adjustment:</strong></td>
</tr>
<tr>
<td>• increase SG&amp;A expense by the amount of “pre-tax” pro-forma stock compensation expense; and</td>
</tr>
<tr>
<td>• reduce tax expense by the amount of the incremental tax rate times the pre-tax pro-forma stock compensation expense.</td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
</tr>
<tr>
<td><strong>We adjust the cash flow statement to reclassify the tax benefit from stock option exercises from an operating cash inflow (CFO) to a financing cash inflow (CFF).</strong></td>
</tr>
</tbody>
</table>
THE REPORTING PROBLEM
Although accounted for as debt, equity or minority interest, hybrid securities have characteristics of both debt and equity instruments. For some instruments, accounting standards focus on legal form, even though the economics of these instruments suggest a different classification. For example, standards classify certain preferred stocks as 100% equity, even though these instruments have important attributes of debt.

MOODY’S ANALYTICAL RESPONSE
Since hybrid securities are generally not pure debt or pure equity, Moody’s places a particular hybrid security on a debt - equity continuum. We assign weights to the debt and equity components of a hybrid based on the security’s particular features. The weights determine where it lies on the continuum. As a result, for example, Moody’s may view a particular hybrid as 75% debt and 25% equity, while accounting standards may classify the instrument as 100% equity.

On the balance sheet we classify the instrument in accordance with the weights we assign to its equity and debt features:

<table>
<thead>
<tr>
<th>Basket</th>
<th>Debt Component</th>
<th>Equity Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>C</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>D</td>
<td>25%</td>
<td>75%</td>
</tr>
<tr>
<td>E</td>
<td>0%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Often this requires an adjustment from the classification in current accounting, which often classifies instruments as all debt or all equity, or in some cases, minority interest.

We also adjust the income statement to reflect interest expense or dividends, depending on our balance sheet classification. For example, if we deem a portion of a debt instrument as “equity - like”, Moody’s reclassifies the ratable amount of interest expense to dividends. Conversely, if we deem a portion of an equity instrument as “debt - like”, Moody’s reclassifies the ratable amount of dividends to interest expense.

We apply similar thinking to the cash flow statement, again reflecting cash outflows as interest or dividends depending on our balance sheet classification.

In a change from Moody’s previous methodology, “Hybrid Securities Analysis,” November 2003, we will adjust financial statements for hybrid securities and calculate ratios in the same manner for both investment grade and non-investment grade issuers.

HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS
The following table describes Moody’s adjustments related to hybrid securities. Worksheet E in the Appendix provides the detail underlying the calculations.

Table 6: Reclassification to Equity for Hybrid Securities Classified as Debt

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>We adjust the balance sheet to reclassify to equity (i.e. preferred stock) hybrid securities classified as debt, based on the hybrid basket treatment assigned to the particular hybrid security.</td>
<td>We adjust the income statement to reclassify interest expense to preferred dividends for the calculated equity portion of hybrid securities based on the hybrid basket treatment.</td>
<td>We adjust the cash flow statement to reclassify interest expense (an operating cash outflow) to preferred dividends (a financing cash outflow) for the calculated equity portion of hybrid securities based on the hybrid basket treatment.</td>
</tr>
</tbody>
</table>

8. Hybrid Securities Analysis: New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities, November 2003, established that fixed charge coverage ratios would generally not be adjusted for high-grade issuers while coverage ratios for lower-rated issuers would be calculated both with and without hybrid coupons that are defeasible, payable-in-kind, or payable in common stock. In a change from this methodology, Moody’s now adjusts financial statements for hybrid securities depending on the basket designation and calculates ratios in the same manner for both investment grade and non-investment grade issuers.
Accounting standards classify certain hybrid instruments as neither debt nor equity, but as minority interest. In contrast, we reclassify these hybrids proportionally to debt and equity as determined by the weightings assigned in accordance with the hybrid securities continuum. We also adjust the income and cash flow statements for these securities, consistent with our classification on the balance sheet.

Standard Adjustment #6: Securitizations

THE REPORTING PROBLEM
Companies often report as a sale the transfer of assets, such as receivables, to securitization trusts, following accounting rules that are largely based on legal form. However, in many of these securitizations accounted for as sales:

1. the company sponsor retains key risks related to the assets transferred to the securitization trust,
2. the company, to maintain market access for future securitization, would be “economically compelled” to rescue a prior securitization transaction, or
3. in the event that the company lost access to the securitization market, the types of assets normally securitized would quickly accumulate on the sponsor’s balance sheet, through the company’s normal business activities, and require alternative funding.

These facts, if present, raise complex questions about whether the analyst covering a non-financial corporation should view the securitization as a sale of assets or a borrowing collateralized by assets. The accounting and resulting numbers related to the company’s financial leverage and cash flows differ significantly depending upon which view the analyst accepts.

For example, if the transaction is viewed as a sale, then the analyst accepts the accounting. That accounting removes the assets from the company’s balance sheet and recognizes no debt related to the transaction. On the cash flow statement, the company classifies cash inflow from the sale of receivables in cash from operations.

However, if the transaction is viewed as a collateralized borrowing, then the analyst adjusts the company’s balance sheet to record debt for the proceeds from the securitization and to include the receivables or other assets that the company securitized. On the cash flow statement, the analyst reclassifies cash inflow from the transaction from cash from operations (CFO) to cash from financing activities (CFF), viewing the proceeds as borrowing.

Accounting standards that treat collateralized borrowings as sales result in non-comparable reporting among companies. Companies that borrow from traditional sources appear different from those that borrow through securitization transactions, even though the economics of the borrowings may be similar.

MOODY’S ANALYTICAL RESPONSE
Moody’s views securitization transactions that do not fully transfer risk as collateralized borrowings. In nearly all of the securitizations we have reviewed to date, company sponsors have retained significant risks related to the assets transferred. In those cases, we adjust the financial statements of companies that report securitizations as sales to reflect the transactions as collateralized borrowings.

HOW MOODY’S ADJUSTS FINANCIAL STATEMENTS
The following table describes Moody’s adjustments for securitizations that sponsors report as sales but that do not fully transfer risk. Worksheet F in the Appendix provides the detail underlying the calculations.

| Table 7: Reclassification to Debt for Hybrid Securities Classified as Equity |
| Balance Sheet | We adjust the balance sheet to reclassify to debt (i.e. subordinated debt) hybrid securities classified as equity, based on the hybrid basket treatment assigned to the particular hybrid security. |
| Income Statement | We adjust the income statement to reclassify preferred dividends to interest expense for the calculated debt portion of hybrid securities based on the hybrid basket treatment. |
| Cash Flow Statement | We adjust the cash flow statement to reclassify preferred dividends (a financing cash outflow) to interest expense (an operating cash outflow) for the calculated debt portion of hybrid securities based on hybrid basket treatment. |
Standard Adjustment #7: Inventory on a LIFO Cost Basis

THE REPORTING PROBLEM

LIFO (last-in-first-out) cost method for carrying inventories on the balance sheet is an accounting choice under US and Canadian GAAP and is not an acceptable accounting method under other GAAPs, including international accounting standards. In periods of rising prices, the LIFO method can cause the carrying value of inventory on the balance sheet to be well below FIFO (first-in-first-out) value, replacement cost, and market value. Accordingly, the balance sheets of companies electing the LIFO cost method are not comparable to those that follow FIFO or other methods.

MOODY’S ANALYTICAL RESPONSE

Moody’s adjusts inventories that companies report on the LIFO cost method to the FIFO cost method. This adjustment improves our ability to compare a company with others. It also states inventory at a more relevant amount (the current cost of the inventory).

This adjustment only affects the balance sheet. We do not adjust the income or cash flow statements because we view cost of goods sold measured on the LIFO basis as an accurate representation of the current cost of inventories sold.

HOW MOODY’S ADJUSTS THE FINANCIAL STATEMENTS

The following table describes Moody’s adjustment to inventory measured on LIFO. Worksheet G in the Appendix provides the detail underlying the calculations.

<table>
<thead>
<tr>
<th>Table 9: Standard Adjustments for Inventory on a LIFO Cost Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td>We adjust the balance sheet to:</td>
</tr>
<tr>
<td>• increase inventories by the amount of the LIFO inventory valuation reserve</td>
</tr>
<tr>
<td>• increase deferred tax liabilities for applicable tax effects</td>
</tr>
<tr>
<td>• increase retained earnings.</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td>We do not adjust the income statement because we view cost of goods sold on a LIFO basis as an accurate representation of the current cost of inventories sold.</td>
</tr>
<tr>
<td><strong>Cash Flow</strong></td>
</tr>
<tr>
<td>We do not adjust the cash flow statement</td>
</tr>
</tbody>
</table>
The Reporting Problem
Financial statements generally do not contain enough information about unusual or non-recurring items to meet analysts' needs for information. Although companies separately display the effects of a few non-recurring transactions and events (e.g. discontinued operations, extraordinary items, and effect of change in accounting principles), accounting standards fail to require or permit companies to separately display on the face of the statements a sufficiently broad range of unusual or non-recurring items.

Examples include:
• Unusually large transactions (creating revenues, costs or cash flows) that management does not expect to recur in the foreseeable future
• Unique transactions, such as selling real estate by a company that rarely sells real estate
• Transactions that have occurred in the past but that management expects will soon cease (for example, the tax benefits of deductible goodwill whose depreciable life is ending).

Inadequate information about the effects of unusual or non-recurring items can foster misleading impressions about key trends in financial data. For example, the revenues, gross margin and cash flows resulting from a one-time unusually large sale, if not separately considered could create a misleading impression about a company's trends in market share, revenue, income and operating cash flow.

Moody's Analytical Response
Moody's captures the effects of unusual and non-recurring transactions and events in separate captions on the face of the income and cash flow statements. This enables analysts to more accurately portray trends in the underlying recurring core business. Our key financial ratios will generally exclude the effects of unusual and non-recurring transactions that we identify.

Generally, we identify unusual and non-recurring transactions and events from public disclosures, including management's discussion and analysis of operations. We may also discuss those types of transactions with management to help ensure that we have considered major items and accurately quantified their effects.

For practical reasons, we generally do not adjust the balance sheet for unusual or non-recurring items. Nevertheless, we will consider the possibility that an unusual or non-recurring item could materially affect the balance sheet, and adjust it too, if needed.

How Moody's Adjusts the Financial Statements
The following table describes Moody's adjustments to capture the effects of unusual and non-recurring items. Analysts use Worksheet H (unusual items - income statement) and Worksheet I (unusual items - cash flow) in the Appendix to capture the information.

<table>
<thead>
<tr>
<th>Table 10: Standard Adjustments for Unusual and Non-Recurring Items - Income and Cash Flow Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
</tr>
</tbody>
</table>
Changes to Standard Adjustments

Over time, we may modify our standard adjustments as global reporting issues evolve. If so, we will alert readers of our research and, where appropriate, solicit comment prior to doing so and will update this methodology.

Appendix — Adjustment Worksheets

Attached are worksheets that show the calculations underlying each of the adjustments.

<table>
<thead>
<tr>
<th>Worksheet</th>
<th>Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Underfunded/Unfunded defined benefit pensions</td>
</tr>
<tr>
<td>B</td>
<td>Operating leases</td>
</tr>
<tr>
<td>C</td>
<td>Capitalized Interest</td>
</tr>
<tr>
<td>D</td>
<td>Employee stock compensation</td>
</tr>
<tr>
<td>E</td>
<td>Hybrid securities</td>
</tr>
<tr>
<td>F</td>
<td>Securitizations</td>
</tr>
<tr>
<td>G</td>
<td>Inventory on a LIFO cost basis</td>
</tr>
<tr>
<td>H</td>
<td>Unusual and non-recurring items - income statement</td>
</tr>
<tr>
<td>I</td>
<td>Unusual and non-recurring items - cash flow statement</td>
</tr>
<tr>
<td>J</td>
<td>Non-standard adjustment - public information</td>
</tr>
</tbody>
</table>
Adjustment: Pensions — Worksheet (A) (US GAAP version)

Background
Moody’s believes that a sponsor’s balance sheet should reflect a liability equal to the under funded status of its defined benefit pension plan. We measure that liability at the balance sheet date as the excess of the actuarially determined projected benefit obligation (PBO) over the fair value of assets in the pension trust. To improve comparability with pre-funded pensions, Moody’s simulates a pre-funding of pension obligations for companies that are not required to pre-fund. Consequently, for unfunded pension plans, the PBO is only partly considered as “debt-like.” On the income statement, our goal is to report pension expense absent the effects of artificial smoothing, such as the amortization of prior service cost and actuarial gains and losses. We view pension expense to equal the year’s service cost, plus interest on the gross pension obligations (PBO), minus actual earnings on plan assets. On the cash flow statement, we view cash contributions in excess of service cost as the repayment of (pension) debt.

Company:

Financial Statement Period Ended:

Amounts in US$’000

Step 1 - Pension Disclosure Information (Common Input for Both Underfunded and Unfunded Plans)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected Benefit Obligation (End of Year)</td>
<td></td>
</tr>
<tr>
<td>Fair Value of Plan Assets (End of Year)</td>
<td></td>
</tr>
<tr>
<td>Net Periodic Pension Benefit Cost (Income)</td>
<td></td>
</tr>
<tr>
<td>Service Cost</td>
<td></td>
</tr>
<tr>
<td>Interest Cost</td>
<td></td>
</tr>
<tr>
<td>Actual Return on Plan Assets</td>
<td></td>
</tr>
<tr>
<td>Employer Contributions</td>
<td></td>
</tr>
<tr>
<td>Pension Asset Recorded</td>
<td></td>
</tr>
<tr>
<td>Pension Liability Recorded</td>
<td></td>
</tr>
</tbody>
</table>

Step 2 - Additional Pension Disclosure Information for Unfunded Pension Plans

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unfunded Projected Pension Benefit Obligation (End of Year)</td>
<td></td>
</tr>
<tr>
<td>Service Cost for Unfunded Pensions (excl OPEB - if disclosed)</td>
<td></td>
</tr>
</tbody>
</table>

Step 3 - Other Disclosure Information Used in Calculations:

a. Common Input for Both Underfunded and Unfunded Plans

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods/Products/Services Sold</td>
<td></td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td></td>
</tr>
<tr>
<td>Incremental LT Borrowing Interest Rate</td>
<td></td>
</tr>
<tr>
<td>Incremental Tax Rate</td>
<td></td>
</tr>
</tbody>
</table>

b. Additional Input for Unfunded Plans

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analyst Estimate: &quot;Ideal&quot; Percentage of Debt to Debt + Equity</td>
<td></td>
</tr>
<tr>
<td>Analyst Estimate: &quot;Excess&quot; cash related to unfunded pensions</td>
<td></td>
</tr>
</tbody>
</table>

Guideline: Excess cash = Liquid funds less 3% of sales. Excess cash should not exceed the unfunded pension obligation (l)
**Step 4 - Adjustments**

**[A]-1 (Balance Sheet) If Plan is Unfunded or Underfunded**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Other Comprehensive Income $</td>
<td>$ - (h) - (i) - (s) - (t)</td>
</tr>
<tr>
<td>Deferred Tax Liabilities -</td>
<td>-</td>
</tr>
<tr>
<td>Pension Liabilities Recorded -</td>
<td>- (i)</td>
</tr>
<tr>
<td>Pension Assets Recorded -</td>
<td>-</td>
</tr>
<tr>
<td>Bonds/Senior Debt -</td>
<td>(t) if (a) - (j) &gt; (b) then (b) - (a) else (i) x -1</td>
</tr>
</tbody>
</table>

**Purpose:** To record underfunded and unfunded pension balance as debt.

**[A]-2 (Balance Sheet - Unfunded Pensions)**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Debt $ -</td>
<td>- (u) x [1 - (q)]</td>
</tr>
<tr>
<td>Total Retained Earnings -</td>
<td>(u) x -1</td>
</tr>
</tbody>
</table>

**Purpose:** To give equity credit to a portion of the company’s unfunded pension liability.

**[A]-3 (Income Statement)**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods/Products/Services Sold $ -</td>
<td>-</td>
</tr>
<tr>
<td>Operating Expenses -</td>
<td>-</td>
</tr>
<tr>
<td>Selling, general and administrative expenses -</td>
<td>-</td>
</tr>
<tr>
<td>Other Non-Recurring Expenses/(Gains) -</td>
<td>- (v) if (e) - (w) &gt; (f) then (e) - (w) - (f)</td>
</tr>
<tr>
<td>Interest Expense -</td>
<td>(w) = [(u) + (t)] x (o) x -1</td>
</tr>
<tr>
<td>Taxes -</td>
<td>(x) = [(d) - (c) + (v) + (w)] x (p) x -1</td>
</tr>
<tr>
<td>Unusual &amp; Non-Recurring Items - Adjust. After-tax -</td>
<td>[(d) - (c) + (v) + (w) + (x)] x -1</td>
</tr>
</tbody>
</table>

**Purpose:** To properly reflect pension costs on the Income Statement.

**[A]-4 (Cash Flow Statement)**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in Other Oper. Assets &amp; Liabilities - LT $ -</td>
<td>- If (g) &gt; (d) - (k) then (g) - [(d) - (k)]</td>
</tr>
<tr>
<td>Other Financing Activities -</td>
<td>-</td>
</tr>
</tbody>
</table>

**Purpose:** To align cash flow treatment of underfunded pension costs with balance sheet treatment.
**Adjustment: Leases — Worksheet (B)**

**Background**
For operating leases, companies do not recognize debt even though they are contractually obligated for lease payments and a failure to make a lease payment often triggers events of default, as if the obligation were debt. Further, in the eyes of lenders, incurring operating lease obligations reduces a company’s borrowing capacity and in the absence of a lease financing option, the company would likely borrow the money and buy the asset. To address the problems listed above, Moody’s treats all leases as capital leases and adjusts the balance sheet income statement and cash flow statement accordingly. Our adjustment is calculated using a multiple of rent expense, but in no case should the operating lease liability be lower than the present value of lease commitments.

1. **Company Name:**
2. **Financial Statement Period Ended:**
   - Amounts in US$’000

**Step 1 - Use Multiple to Calculate Capitalized Lease Obligation**

<table>
<thead>
<tr>
<th>Current Year Rent Expense</th>
<th>(a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiple of Rent to be used to calculate debt:</td>
<td>(b)</td>
</tr>
<tr>
<td>Multiple x Rent Expense</td>
<td>(c) = (a) x (b)</td>
</tr>
</tbody>
</table>

**Step 2 - Use Minimum Lease Commitments to Calculate Present Value**

Incremental LT Borrowing Interest Rate | (d) |

<table>
<thead>
<tr>
<th>Disclosure of Minimum Lease Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 (next fiscal year)</td>
</tr>
<tr>
<td>Year 2</td>
</tr>
<tr>
<td>Year 3</td>
</tr>
<tr>
<td>Year 4</td>
</tr>
<tr>
<td>Year 5</td>
</tr>
<tr>
<td>Thereafter</td>
</tr>
</tbody>
</table>

Sum of Minimum Lease Commitments - (f)

PV of Lease Commitments - (f)

**Step 3 - Calculate Adjustment to Debt / PP&E, Interest Expense, and Depreciation Expense**

<table>
<thead>
<tr>
<th>Incremental Debt and Addition to PP&amp;E</th>
<th>(g) - Greater of Multiple x Rent Expense (c) and PV of Minimum Lease Commitments (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Component of Rent Expense</td>
<td>(h) - Current Year Rent Expense (a) x ⅔</td>
</tr>
<tr>
<td>Interest Component of Rent Expense</td>
<td>(i) - Current Year Rent Expense (a) x ⅔</td>
</tr>
</tbody>
</table>

**Step 4 - Other Disclosure Information and Analyst Estimates Used in Calculations:**

- Cost of Goods/Products/Services Sold - (j)
- Operating Expenses - (k)
- Selling, general and administrative expenses - (l)
Step 5 - Adjustments

(B)-1 (Balance Sheet)

<table>
<thead>
<tr>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Plant</td>
<td>$ -</td>
</tr>
<tr>
<td>Capitalized Leases (Gross)</td>
<td>- (g) x -1</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>- (e) x ½ x -1</td>
</tr>
<tr>
<td>Less: Current Maturities</td>
<td>- (e) x ½</td>
</tr>
</tbody>
</table>

Purpose: To recognize capitalized lease obligation and addition to PP&E.

(B)-2 (Income Statement)

<table>
<thead>
<tr>
<th>Source</th>
<th>(Use)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$ -</td>
</tr>
<tr>
<td>Cost of Goods/Products/Services Sold</td>
<td>- (i) x [(j) / (j) + (k) + (l)] x -1</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>- (i) x [(k) / (j) + (k) + (l)] x -1</td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td>- (i) x [(l) / (j) + (k) + (l)] x -1</td>
</tr>
<tr>
<td>Depreciation - Capitalized Operating Leases</td>
<td>- (h)</td>
</tr>
<tr>
<td>Cost of Goods/Products/Services Sold</td>
<td>- (h) x [(j) / (j) + (k) + (l)] x -1</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>- (h) x [(k) / (j) + (k) + (l)] x -1</td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td>- (h) x [(l) / (j) + (k) + (l)] x -1</td>
</tr>
</tbody>
</table>

Purpose: To reclassify rent expense into interest and depreciation expense.

(B)-3 (Cash Flow Statement)

<table>
<thead>
<tr>
<th>Source</th>
<th>(Use)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation &amp; Amortization</td>
<td>$ -</td>
</tr>
<tr>
<td>Long-term Debt Payments</td>
<td>- (h) x - 1</td>
</tr>
<tr>
<td>Long-term Debt Proceeds</td>
<td>- (h)</td>
</tr>
<tr>
<td>Additions to P.P. &amp; E. (Capital Expenditures)</td>
<td>- (h) x - 1</td>
</tr>
</tbody>
</table>

Purpose: To reclassify depreciation portion of rent expense from depreciation to a financing outflow, and a concomitant borrowing to fund capital expenditures.

Supporting Calculations:

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum Lease Payments</th>
<th>Cumulative Minimum Lease Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>7</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Adjustment: Capitalized Interest — Worksheet (C)

Background
Under certain circumstances, GAAP requires that a company capitalize interest cost as a part of property, plant and equipment (PP&E). In the year a company capitalizes interest, reported capital assets, income and cash flow from operations are all increased relative to what would have been reported had the company expensed all interest. Moody’s views capitalized interest as a cost for obtaining financing (i.e. interest expense) and believes that analysis of interest coverage should expense when incurred all interest cost regardless of whether a company recognizes that cost as an expense on its income statement or capitalized asset on its balance sheet.

Company Name:
Financial Statement Period Ended:
Amounts in US$'000

Step 1 - Identify the amount of interest capitalized during the period and determine whether the amount is material to our analysis:

Capitalized interest - (a)
Interest Expense - (b)
Percentage of interest capitalized to interest expense 0.00% (a) / [(a) + (b)]

Is the amount of interest capitalized considered
Is the amount of interest capitalized considered material to our analysis? (Yes or No) (c) ← Typically we respond “no” if the percentage (above) is less than 5%

Step 2 - Other Disclosure Information Used in Calculations:
Incremental Tax Rate 0.00% (d)

Step 3 - Adjustments (If (c) is “Yes”):

Debit (Credit)
(C)-1 (Balance Sheet)
Long-Term Deferred Tax Account - (e) = (a) x (d)
Total Retained Earnings - = [(f) + (e)] x -1
Gross Plant - (f) = (a) x -1

Purpose: To adjust balance sheet to expense interest that the company capitalized during the current period.

(C)-2 (Income Statement)
Interest Expense - = (a)
Taxes - (g) = (e) x -1
Unusual & Non-Recurring Items - Adjust. After-tax - = [(a) + (g)] x -1

Purpose: To adjust income statement to expense interest that the company capitalized during the current period.

(C)-3 (Cash Flow Statement)
Additions to P.P. & E. (Capital Expenditures) - (a)
Net Income - (e) - (a)
Deferred Income Taxes - (e) x -1

Purpose: To reclassify capitalized interest from an investing cash out flow to an operating cash out flow on the cash flow statement.
Adjustment: Employee Stock-Based Compensation — Worksheet (D)

Background
Most companies do not yet expense employee stock options (ESOs), although many do so. Moody’s believes that employee stock options are a form of compensation that should be expensed for purposes of analysis. Additionally, despite the fact that accounting guidance treats the reduction in the tax benefits related to ESO’s as an increase to operating cash flow in the cash flow statement, Moody’s believes that the tax benefit from stock option exercises is best viewed as a financing cash in-flow. This adjustment will be made to financial statements through June 30, 2005, at which time new accounting rules take effect that will require all companies to expense the cost of ESOs.

Company Name:
Financial Statement Period Ended:

Amounts in US$'000
Step 1 - Gather information on the cost of stock-based employee compensation and determine if amounts are material:
Reported Net Income - (a) ← from the Income Statement
Pro-Forma Net Income as if the company had expensed the cost of employee stock options - (b) ← from the financial statement footnotes (usually note 1)
Percentage reduction in Net Income if the company were to have expensed the effect of employee stock options 0.00% [(a) - (b)] / (a)
Is the amount of stock compensation considered material to our analysis? (Yes or No) - (c) ← Typically we respond “no” if the percentage (above) is less than 3%

Step 2 - Other Disclosure Information Used in Calculations:
Tax benefit from stock option exercises - (d) ← amount (if material) is disclosed on the Cash Flow Statement, Statement of Stockholders’ Equity or the financial statement footnotes
Incremental Tax Rate 0.00% (e)

Step 3 - Adjustments:

<table>
<thead>
<tr>
<th>(D)-1 (Balance Sheet / Income Statement) - if (c) is “Yes”</th>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expenses</td>
<td>$ -</td>
<td>(f) = [(a) - (b)] / [1 - (e)]</td>
</tr>
<tr>
<td>Long Term Deferred Tax Account</td>
<td>-</td>
<td>(g) = (f) x (e)</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>-</td>
<td>(h) = (f) x (e)</td>
</tr>
<tr>
<td>Common Stock &amp; Paid-in-Capital</td>
<td>$ -</td>
<td>= (f) x -1</td>
</tr>
<tr>
<td>Taxes</td>
<td>-</td>
<td>= (g) x -1</td>
</tr>
<tr>
<td>Unusual &amp; Non-Recurring Items - Adjustments After Tax</td>
<td>$ -</td>
<td>= (h) x -1</td>
</tr>
</tbody>
</table>

Purpose: To adjust the income statement and balance sheet as if stock options had been recorded as an expense

<table>
<thead>
<tr>
<th>(D)-2 (Cash Flow Statement)</th>
<th>Inflow</th>
<th>(Outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Option/Warrant Proceeds (Financing Cash Flows)</td>
<td>$ -</td>
<td>(d)</td>
</tr>
<tr>
<td>Other Operating Cash Flows (Operating Cash Flows)</td>
<td>$ -</td>
<td></td>
</tr>
</tbody>
</table>

Purpose: To reclassify tax benefits from stock options from an operating cash inflow to a financing cash inflow
Adjustment: Hybrid Securities — Worksheet (E)

Background
Although accounted for as debt, equity or minority interest, hybrid securities have characteristics of both debt and equity instruments. Since hybrid securities are generally not pure debt or pure equity, Moody’s places a particular hybrid security on a debt – equity continuum. We assign weights to the debt and equity components of a hybrid based on the security’s particular features. Often this requires an adjustment from the classification in current accounting, which often classifies instruments as all debt or all equity, or in some cases, minority interest. We also adjust the income statement to reflect interest expense or dividends, depending on our balance sheet classification. Finally, we apply similar thinking to the cash flow statement, again reflecting cash outflows as interest or dividends depending on our balance sheet classification.

Company Name:
Financial Statement Period Ended:
Amounts in US$’000

<table>
<thead>
<tr>
<th>Moody’s Hybrid Securities Baskets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Basket</td>
<td>Moody’s % Equity</td>
</tr>
<tr>
<td>A</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>25%</td>
</tr>
<tr>
<td>C</td>
<td>50%</td>
</tr>
<tr>
<td>D</td>
<td>75%</td>
</tr>
<tr>
<td>E</td>
<td>100%</td>
</tr>
</tbody>
</table>

Step 1 - Gather information on Hybrid Securities Classified as Debt (in the “As Reported” numbers):

<table>
<thead>
<tr>
<th>Amount Outstanding</th>
<th>Est. Interest Expense</th>
<th>Moody’s Basket</th>
<th>Reclass to Equity</th>
<th>Reclass to Preferred Dividends</th>
<th>Description of Hybrid Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid Security #1</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #2</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #3</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #4</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Total Reclassifications $ - (a) $ (b)

Step 2 - Gather information on Hybrid Securities Classified as Equity (in the “As Reported” numbers):

<table>
<thead>
<tr>
<th>Amount Outstanding</th>
<th>Dividends</th>
<th>Moody’s Basket</th>
<th>Reclass to Debt</th>
<th>Reclass to Interest Expense</th>
<th>Description of Hybrid Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid Security #1</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #2</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #3</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Hybrid Security #4</td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Total Reclassifications $ - (c) $ (d)
Step 3 - Gather information on Hybrid Securities Classified as Minority Interest (in the “As Reported” numbers):

<table>
<thead>
<tr>
<th>Description of Hybrid Security</th>
<th>Amount Outstanding</th>
<th>Amount Charged to Expense</th>
<th>Moody’s Basket Reclass to Debt</th>
<th>Reclass to Interest Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid Security #1</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hybrid Security #2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hybrid Security #3</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hybrid Security #4</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Total Reclassifications $ (g) $ (h)

Step 4 - Adjustments:

(E)-1 (Balance Sheet)

Debit | (Credit)
--- | ---
$ - | -

Hybrid securities classified as debt in the “as reported” numbers may be included in multiple account captions on the standard chart of accounts. Analysts will need to manually enter the standard adjustment accounts effected by the adjustment and the related amounts (based on the calculation above).

(E)-2 (Balance Sheet)

Preferred Stock $ - (a)

Purpose: Reclassification to equity for hybrid securities classified as debt (based on the basket calculation in Step 1 - above)

(E)-3 (Balance Sheet)

Subordinated debt $ -

Purpose: Reclassification to debt for hybrid securities classified as equity (based on the basket calculation in Step 2 - above)

(E)-4 (Income Statement)

Debit | (Credit)
--- | ---
$ - | -

Adjustment of interest expense to preferred dividends for the calculated equity portion of hybrid securities classified as debt in the “As Reported” numbers (based on the basket calculation in Step 1 - above)

(E)-5 (Income Statement)

Preferred Dividends Declared $ - (b)

Purpose: Adjustment of interest expense to preferred dividends for the calculated equity portion of hybrid securities classified as debt in the “As Reported” numbers (based on the basket calculation in Step 1 - above)

(E)-6 (Income Statement)

Interest Expense $ - (d)

Purpose: Adjustments of preferred dividends to interest expense for the calculated debt portion of hybrid securities classified as equity in the “As Reported” numbers (based on the basket calculation in Step 2 - above)
### (E)-5 (Cash Flow Statement)

<table>
<thead>
<tr>
<th>Inflow</th>
<th>(Outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income (Operating Cash Flow)</td>
<td>$(b)$</td>
</tr>
<tr>
<td>Cash Dividends Preferred</td>
<td>$-$</td>
</tr>
</tbody>
</table>

**Purpose:** Reclassification of interest expense (operating cash outflow) to preferred dividends (financing cash outflow) for the calculated equity portion of hybrid securities classified as debt in the "As Reported" numbers (based on the basket calculation in Step 1 - above)

### (E)-6 (Cash Flow Statement)

<table>
<thead>
<tr>
<th>Inflow</th>
<th>(Outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Dividends Preferred</td>
<td>$(d)$</td>
</tr>
<tr>
<td>Net Income (Operating Cash Flow)</td>
<td>$-$</td>
</tr>
</tbody>
</table>

**Purpose:** Reclassification of preferred dividends (financing cash outflow) to interest expense (operating cash outflow) for the calculated debt portion of hybrid securities classified as equity in the "As Reported" numbers (based on the basket calculation in Step 1 - above)

### (E)-7 (Balance Sheet)

<table>
<thead>
<tr>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minority Interest</td>
<td>$=$ ( \sum (e) )</td>
</tr>
<tr>
<td>Subordinated debt</td>
<td>$=$ ( (g) \times -1 )</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$=$ ( \left( \sum (e) - (g) \right) \times -1 )</td>
</tr>
</tbody>
</table>

**Purpose:** Reclassification to debt and equity (preferred stock) for hybrid securities classified as Minority Interest (based on the basket calculation in Step 3 - above)

### (E)-8 (Income Statement)

<table>
<thead>
<tr>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>$=$ ( (h) )</td>
</tr>
<tr>
<td>Preferred Dividends Declared</td>
<td>$=$ ( \sum (f) - (b) )</td>
</tr>
</tbody>
</table>

**Purpose:** Adjustment of interest expense and preferred dividends for the calculated debt/equity portions of hybrid securities classified as minority interest in the "As Reported" numbers (based on the basket calculation in Step 3 - above)

### (E)-9 (Cash Flow Statement)

<table>
<thead>
<tr>
<th>Inflow</th>
<th>(Outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income - Preferred Dividends</td>
<td>$=$(f)</td>
</tr>
<tr>
<td>Cash Dividends</td>
<td>$=$(h) \times -1</td>
</tr>
</tbody>
</table>

**Purpose:** Reclassification of minority interest expense (operating cash outflow) or minority interest dividends (financing cash outflow) to preferred dividends (financing cash outflow) and interest expense (operating cash outflow) for the calculated equity portion of hybrid securities classified as minority interest in the "As Reported" numbers (based on the basket calculation in Step 3 - above)
Adjustment: Securitizations — Worksheet (F)

Background
Moody's views securitization transactions that do not fully transfer risk as collateralized borrowings. In nearly all of the securitizations we have reviewed to date, company sponsors have retained significant risks related to the assets transferred. In those cases, we adjust the financial statements of companies that report securitizations as sales to reflect the transactions as securitized borrowings.

Company Name:
Financial Statement Period Ended:

Amounts in US$'000

Step 1 - Gather Information about Securitization Transactions (from financial statement footnotes):

| Amount of uncollected/unrealized sponsor assets in the securitization arrangement at the beginning of the period | (a) |
| Amount of uncollected/unrealized sponsor assets in the securitization arrangement at the end of the period | (b) |
| Estimated average amount of uncollected/unrealized sponsor assets in the securitization arrangement during the period | (c) — Analyst estimate based on quarterly disclosures |
| Estimated borrowing rate implicit in the company's securitization arrangement | 0.00% (d) — If rate is not known, use the company's average short-term borrowing rate |

Step 2 - Adjustments:

<table>
<thead>
<tr>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(F)-1 (Balance Sheet)</td>
<td></td>
</tr>
<tr>
<td>Asset account to be adjusted</td>
<td>$ -</td>
</tr>
<tr>
<td>Liability account to be adjusted</td>
<td>$ - (b) — Analyst will have to enter the name of the asset account affected</td>
</tr>
<tr>
<td>Purpose: To recognize assets not sold and uncollateralized borrowings based on the amount of uncollected/unrealized sponsor assets in the securitization arrangement at the end of the period</td>
<td></td>
</tr>
</tbody>
</table>

| (F)-2 (Income Statement) |
| Interest Expense | $ - |
| Income statement account to be used for adjustment against interest expense | $ - (c) x (d) |
| Purpose: To impute interest expense on the amount of unrecognized debt at the company's short-term borrowing rate |

<table>
<thead>
<tr>
<th>Inflow</th>
<th>(Outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(F)-3 (Cash Flow Statement)</td>
<td></td>
</tr>
<tr>
<td>Changes in Working Capital Items</td>
<td>$ -</td>
</tr>
<tr>
<td>Net Short-term Debt Changes</td>
<td>$ - (a) - (b)</td>
</tr>
<tr>
<td>Purpose: To recognize the cash effects of changes in unrecognized assets and debt from the beginning to the end of the period</td>
<td></td>
</tr>
</tbody>
</table>
Adjustment: Inventory - LIFO to FIFO — Worksheet (G)

Background
Moody’s adjusts inventories that companies report on the LIFO cost method to the FIFO cost method. This adjustment improves our ability to compare a company with others. It also states inventory at a more relevant amount (the current cost of the inventory). This adjustment only affects the balance sheet. We do not adjust the income or cash flow statements because we view cost of goods sold measured on the LIFO basis as an accurate representation of the current cost of inventories sold.

Company Name: 
Financial Statement Period Ended:

Amounts in US’000

Step 1 - Gather Disclosure Information related to Inventories:
- Inventories (as reported) - (a)
- LIFO Revaluation Reserve (b) ← from the financial statement footnotes
- Inventory at FIFO - (c) = (a) - (b)

Step 2 - Other Disclosure Information Used in Calculations:
- Incremental Tax Rate 0.00% (d)

Step 3 - Adjustments:

<table>
<thead>
<tr>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(G)-1 (Balance Sheet)</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>$</td>
</tr>
<tr>
<td>Current Deferred Tax Account</td>
<td>-</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>-</td>
</tr>
</tbody>
</table>

Purpose: To adjust inventory on the balance sheet from a LIFO cost basis to a FIFO cost basis.
Adjustment: Unusual Items - Income Statement — Worksheet (H)

Background
Moody's captures the effects of unusual and non-recurring transactions and events in separate captions on the face of the income statement. This enables analysts to more accurately portray trends in the underlying recurring core business. Our key financial ratios will generally exclude the effects of unusual and non-recurring transactions that we identify.

- To increase a reported amount, enter a positive number. For example, an analyst may want to increase Cost of Sales if he believed the reported amount was lowered by exceptionally low commodity prices that distort comparability.
- To decrease a reported amount, enter a negative number. For example, an analyst may want to reduce Operating Expenses if the reported results included restructuring charges which the analyst deems non-recurring.

Company Name:
Financial Statement Period Ended:

Amounts in US$'000

Step 1 - Gather information on Unusual and/or Non-recurring Income/Gains and Expenses/Losses:

<table>
<thead>
<tr>
<th>Account Affected</th>
<th>Revenue/Gains (a)</th>
<th>Taxable (b)</th>
<th>Non-Taxable (c)</th>
<th>Description of Unusual Item</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Increase (Decrease)</td>
<td>Increase (Decrease)</td>
<td>Increase (Decrease)</td>
<td></td>
</tr>
</tbody>
</table>

Net Pre-Tax Effect of Unusual/Non-Recurring Items: 
- (d) = Increase (Decrease) to EBIT \[ \sum \text{Column (a)} - \sum \text{Column (b)} - \sum \text{Column (c)} \]

Income Tax Effect - (Increase) / Decrease to Income Tax Expense: 
- (e) = ( \sum \text{Column (a)} - \sum \text{Column (b)} ) \times (i) \times -1

After-Tax Effect of Unusual/Non-Recurring Items: 
$ - (f)$

Step 2 - Other Disclosure Information Used in Calculations:
Incremental Tax Rate: 0.00% (i)

Step 3 - Adjustments:

<table>
<thead>
<tr>
<th>(H)-1 (Income Statement)</th>
<th>Debit</th>
<th>(Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unusual &amp; Non-Recurring Items - Adjust. After-tax</td>
<td>-</td>
<td>(f)</td>
</tr>
<tr>
<td>Taxes</td>
<td>-</td>
<td>(e) \times -1</td>
</tr>
</tbody>
</table>

Purpose: Reclassification unusual/non-recurring revenues/gains and expenses/losses, net of the related tax effect, to a special income statement caption.
Adjustment: Unusual Items - Statement of Cash Flows — Worksheet (I)

Background
Moody’s captures the effects of unusual and non-recurring transactions and events in separate captions on the face of the statement of cash flows. This enables analysts to more accurately portray trends in the underlying recurring core business. Our key financial ratios will generally exclude the effects of unusual and non-recurring transactions that we identify.

- To increase net cash flow from operations (e.g., to reverse the impact of a significant one time litigation settlement payment), enter a positive number.
- To decrease net cash flow from operations (e.g., to reverse the impact of the receipt of significant proceeds from an insurance settlement), enter a negative number.

Company Name:
Financial Statement Period Ended:

Amounts in US$'000
Step 1 - Gather information on Unusual and/or Non-recurring Operating Cash Inflows and Outflows:

<table>
<thead>
<tr>
<th>Account Affected</th>
<th>Effect on Net Operating</th>
<th>Description of Unusual Item</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Net Effect of Unusual/Non-Recurring Items on Operating Cash Flow $ - (a)

Step 2 - Adjustments:

(I)-1 (Cash Flow Statement)
Unusual & Non-Recurring Items - Cash Flow Adj

Inflow  Outflow
-     -  (a)
-     -
-     -
-     -
-     -
-     -
-     -
-     -

Cash Flow Statement accounts to be adjusted

Purpose: Reclassification unusual/non-recurring operating cash inflows and outflows to a special caption in the operating section of the cash flow statement
Non-Standard Public Adjustments-- Worksheet (J )

**Background**

Moody’s may also make non-standard adjustments to financial statements for matters not covered by the standard adjustments to better reflect underlying economics and improve comparability with peer companies. This template is used for such adjustments that are based on a company’s public disclosures.

**Company Name:**

**Financial Statement Period Ended:**

**Amounts in US$'000**

**Step 1 - Other Disclosure Information Used in Calculations:**

Effective Income Tax Rate 0.00%

**Step 2 - Record Analyst Optional Adjustments:**

<table>
<thead>
<tr>
<th>Adjustment (J) - 1</th>
<th>(a)</th>
<th>(b)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
<th>(e)</th>
<th>(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Assets Increase (Decrease)</td>
<td>Liabilities Increase (Decrease)</td>
<td>Equity Increase (Decrease)</td>
<td>Revenue/Gains Increase (Decrease)</td>
<td>Taxable Expense/Loss Increase (Decrease)</td>
<td>Non-Taxable Increase (Decrease)</td>
<td>Before Unusual Increase (Decrease)</td>
</tr>
<tr>
<td>Balance Sheet or Income Statement accounts to be adjusted</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Taxes</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Unusual &amp; Non-Recurring Items Adjmts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Explanation of Entry:**
Related Research

Rating Methodologies:
- Analytical Observations Related to US Pension Obligations, January 2003 (#77242)
- Off-Balance Sheet Leases: Capitalization and Ratings Implications, October 1999 (#48591)
- Analytical Implications of Employee Stock-Based Compensation, December 2002 (#76852)
- Moody’s Tool Kit: A Framework for Assessing Hybrid Securities, December 1999 (#49802)
- Refinements to Moody’s Tool Kit: Evolutionary, not Revolutionary!, March 2005 (#91696)

Special Comments:
- Demystifying Securitization for Unsecured Investors, January 2003 (#77213)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
Analytical Implications of Accounting for Leases

Neri Bukspan
Managing Director
Standard & Poor's Ratings Services

September 19, 2006
S&P Adjustments to Financial Statements

- Financial statements are not necessarily viewed as “truth” – i.e., as the optimal depiction of the economic reality of the issuer’s financial performance and position.
- Our financial analysis process necessitates making certain analytical adjustments to financial statements to arrive at measures that:
  I. Enable more meaningful peer and period-over-period comparisons;
  II. Better reflect underlying economics;
  III. Better reflect creditors’ risks, rights, and benefits; and
  IV. Facilitate more robust financial forecasts.
Why We Adjust

• Adjusting financials long has been our practice -- it is an integral part of the rating process.

• Although we revise certain amounts reported under applicable GAAP, that does not imply that we challenge:
  – The application of GAAP by the issuer;
  – The adequacy of its audit or financial reporting process; or
  – The appropriateness of GAAP accounting to fairly depict the issuer’s financial position and results for other purposes.

• Rather, it reflects a fundamental difference between accounting and analysis; the accountant necessarily must find one number to use in presenting financial data: The analyst, by definition, picks apart the numbers.

• Good analysis looks at multiple perspectives and uses adjustments as an analytical technique to depict a situation differently for a specific purpose, or to gain another vantage point(s).
Why We Adjust (Cont.)

• The (adjusted) financial measures serve as a baseline for a much broader analytic process, in which we consider myriad other financial and nonfinancial factors (both qualitative and quantitative).

• These include (to name only a few):
  – Economic, regulatory, and geopolitical influences;
  – Management and corporate-governance attributes;
  – Key performance indicators;
  – Financing and liquidity means;
  – Competitive trends;
  – Product-mix considerations;
  – R&D prospects;
  – Patents rights; and
  – Labor relations.

• To that end, supplementary interpretive nonfinancial and trend data are essential (e.g., information provided in the MD&A, and data gathered from our discussions with issuers and other experts).
Analyzing Leasing Arrangements

- The most important point to consider is that leasing is a form of financing!
- We consider the appropriateness of using lease financing in connection with our evaluation of overall capitalization and asset acquisition objectives – and also whether leases are being used to avoid reporting key assets and liabilities.
- Like any other form of financing, leasing has a claim on future cash flows.
- Leases also can give rise to other assets and liabilities with significance to our analysis (including contingent assets or liabilities – such as guarantees and purchase options).
Analyzing Leasing Arrangements (Cont.)

• The analysis must consider covenants (both lease covenants and their impact on other debt covenants), and the recourse or nonrecourse nature of the lease.
• Lessees do not own the leased assets, and leased assets are not available to satisfy claims of the company’s other creditors (in most cases).
• Accounting rules often distort the picture – requiring a recasting of financial information and careful reading of footnotes and MD&A disclosures.
• We do not forget that there are many positive attributes to leasing (e.g., flexibility, tax advantages, and effective all-in cost).
Analytical Considerations

• Lease term (contractual or implied).
• Payments and payment base (e.g., fixed, contingent, CPI-, or LIBOR-based).
• Escalation provisions or rent holidays.
• Purchase options.
• Renewal and early termination options or obligations.
• Residual value guarantees.
• Who pays for executory costs (e.g., insurance, taxes, maintenance, AROs).
• Default provisions/triggers and cross default provisions.
• Economic penalties (which can extend terms, and/or increase costs or reduce flexibility).
Standard & Poor’s Lease Adjustment

- We view the distinction between operating and capital leases as artificial.
- Our lease adjustments seek to enhance comparability of reported results (both operating and financial), and financial obligations among companies.
- The adjustment model is intended to make companies' financial ratios closer to the underlying economics and more comparable, by taking into consideration all financial obligations incurred, whether on or off the balance sheet.
- The model also helps improve analysis of how profitably a company employs both its leased and owned assets.
Balance Sheet & Capital Structure Analysis

- We adjust leverage and capitalization measures to include operating lease-related obligations as follows:
  - We capitalize the present value of lease commitments (based on information obtained from the notes), which is treated as additional financial obligation.
  - We generally use the average interest rate as the discount rate (i.e., interest expense/average debt) from the most recent financials.
  - The resulting present-value figure is added to reported debt (as for finance/capital leases) – included to calculate the total-debt-to-capital and other leverage ratios.
  - The figure also is added to assets to account for the right to use the leased property over the lease term (although less than the cost of the property, this adjustment recognizes that control of the property creates an economic asset).
  - The required lease payments generally are taken gross, rather than netting out sublease income; but, when the head lease and the sublease are matched and the counterparty is sufficiently creditworthy, we would use net payments.
Profitability Analysis

- Rental expense associated with operating leases is reversed.
- The amount is then allocated to interest and depreciation.
- The interest and depreciation adjustments attempt to apportion the periodic cost in a manner akin to debt-financed asset acquisition as follows:
  - We adjust SG&A expenses by adding back the annual expense.
  - The implicit interest cost is calculated by multiplying the average net present value at the end of the current and previous years by the rate used as the discount rate. This figure is added to total interest expense.
  - The lease depreciation is added to reported depreciation expense.
  - The depreciation adjustment is arrived at using a residual calculation by subtracting the implicit interest expense from the annual expense.
  - There is ultimately no change to reported net income as a result of applying the lease analytical methodology.
Cash Flow Analysis

- FFO is increased by the implicit lease depreciation amount.
- The implicit depreciation plus the increase in the net present value of lease payments from year to year is considered as an increase in capital spending (albeit without any corresponding effect on net cash).
- Free cash flow is reduced by the same amount -- this adjustment highlights situations where a company is increasing its level of asset leasing, presumably in lieu of conventional spending.
- Operating lease payments generally are recognized in earnings on a straight-line basis over the lease term, independent of actual cash payments (which might fluctuate, for example, as a result of rent holidays or other incentives). Since this pattern of recognition of expense conforms to the underlying economics of the arrangement (and in most cases adjustments are impractical), we generally do not adjust reported FFO or EBITDA for the difference.
- In calculating cash flows related measures (e.g., EBITDA/Interest) only the implicit interest is added to EBITDA -- the rationale for not including implicit depreciation is that EBITDA is often used as a proxy for cash flow. However, rental expense is a cash expense, and we view it as inappropriate to consider the entire rental expense as being available to pay interest.
Additional Considerations

There are certain inherent limitations to the model:

- In many cases, the computed lease-related debt is significantly understated, because we base our capitalization on the disclosed stream of minimum future rental payments, even when we expect substantial contingent payments; however, in cases where contingent payments are expected to be substantial, we note that the net present value (NVP) adjustments significantly understate the economic commitment and, as a consequence, future cash flows.
- However, contingent rentals are taken into account in computing FFO and EBITDA (i.e., these measures include contingent rental amounts).
- By basing our calculation on the minimum future lease payments, we effectively carve out any consideration of indirect residual risk because under U.S GAAP, if the PV of the minimum payments is 90% or more of the fair value of the asset, the lease is classified as a capital lease. So for operating leases, at least 10% of the value gets overlooked. (A substantially similar outcome will arise under IFRS.)
Broadly, our model does not seek to fully replicate a scenario in which an asset is acquired with debt.

Rather, our adjustment is narrower in scope—it attempts to capture only the debt-equivalent of lease contracts in place.

For example, whenever a company leases for five years an asset with a 20-year productive life, the adjustment picks up only the lease period, ignoring the cost of the entire asset that would have been purchased—and depreciated by an entity that chose to buy instead of lease.

Although both U.S. GAAP and IFRS require disclosure of future lease commitments—data often are not available under other GAAP. In these cases, we will use a multiple of the last annual rental expense to approximate the obligation.

We also treat capital leases as a debt-financed acquisition of an asset: As such, to the extent the cap-ex measure is of analytical significance, we increase the cap-ex measure by that amount.
Proposed Changes to Lease Accounting

• On FASB’s & IASB’s joint agenda—catalyzed by the SEC’s views expressed in its report on “off-balance sheet arrangements” (according to the SEC approximately $1.25 trillion in non cancelable future operating lease commitments are disclosed and are off-balance sheet).

• S&P strongly supports the addition of a comprehensive lease accounting project:
  – Lease accounting is incongruent with other standards.
  – Clarity is needed for the accounting for lease-like arrangements.
  – Disclosures are improving but still lacking—especially for non-SEC registrants and foreign companies not reporting under IFRS.
  – International convergence and greater consistency among issuers would be beneficial to analysts.
Will Ratings Change?

- Because we have been adjusting and considered operating leases in our analysis all along, we do not expect ratings to materially change as a result of a lease accounting change.
- Although we already attribute additional debt for operating leases, the amounts derived from applying our methodology are based on estimates and assumptions which undoubtedly will differ from those that would be recognized under any new lease accounting rules.
- This difference will result because of estimation, and potentially, conceptual differences in what the capitalized amount would represent (e.g., the incorporation of contingent rental in the present-value calculation).
Will Ratings Change (Cont.)?

- However, important rating considerations, with the potential for ratings changes, could still arise because of the following:
  - Covenant and regulatory compliance matters (reported leverage will increase);
  - New accounting or disclosures could reveal new information or risks not previously known to S&P analysts;
  - Adverse market reaction; and
  - Changes in business practices.
For Further Information...

- Standard & Poor’s Corporate Ratings Criteria—Operating Lease Analytics available on Standardandpoors.com and RatingsDirect.com.
- CreditStats Operating Lease Analytical Model available on RatingsDirect.com.
- Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project available on RatingsDirect.com.
- Standard & Poor’s Corporate Ratings Criteria available on Standardandpoors.com.
Corporate Ratings Criteria—Operating Lease Analytics

(Editor’s note: This article, originally published on March 23, 2005, is being republished for inclusion in Standard & Poor’s Ratings Services’ Corporate Ratings Criteria.)

To improve financial ratio analysis, Standard & Poor’s Ratings Services uses a financial model that capitalizes off-balance-sheet operating lease commitments and allocates minimum lease payments to interest and depreciation expenses. Not only are debt-to-capital ratios affected: so are interest coverage, funds from operations to debt, total debt to EBITDA, operating margins, and return on capital. This technique is, on balance, superior to the alternative “factor method”, which multiplies annual lease expense by a factor reflecting the average life of leased assets.

The operating lease model is intended to make companies’ financial ratios more accurate and comparable by taking into consideration all assets and liabilities, whether on or off the balance sheet. In other words, all rated companies are put on a more level playing field, no matter how many assets are leased and how the leases are classified for financial reporting purposes. (We view the distinction between operating leases and capital leases as artificial. In both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments.) The model also helps improve analysis of how profitably a company employs both its leased and owned assets. By adjusting the capital base for the present value of lease commitments, the return on capital better reflects actual asset profitability.

Also, leased assets are not available to corporate creditors in the event of a bankruptcy. The resulting ‘junior’ position of creditors relative to lessors may affect our ratings on specific debt issues. (Note, however, that recovery of lessors’ claims beyond the value of the leased assets themselves also is limited.) If warranted, the debt may be lowered a notch or two from the corporate rating to reflect differences in loss-given-default prospects. Our lease methodology helps highlight the extent of a company’s leasing activity and, therefore, its materiality with respect to such recovery analysis.
Using The Methodology

Lease commitment data for a company are gathered from the notes to its financial statements. Annual data for the coming five years is required for accounts prepared under US GAAP—plus the aggregate amount for subsequent years. Under IFRS, all years need not be individually displayed; the analyst must decide how to best allocate the lump sum to individual years. For the remaining lease years, our model assumes the annual lease payments approximate the minimum payment due in year five. The number of years remaining under the lease is simply the amount “thereafter” divided by the minimum fifth-year payment.

The required lease payments generally are taken gross, rather than netting out sublease income; but, when the head-lease and sublease are matched and the counterparty is sufficiently creditworthy, we would use net payments.

Table 1

Lease Model Calculation

Reported figures: Future minimum lease commitments (mil. $)

<table>
<thead>
<tr>
<th>Payment period</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>61.0</td>
<td>65.8</td>
</tr>
<tr>
<td>Year 2</td>
<td>54.0</td>
<td>53.3</td>
</tr>
<tr>
<td>Year 3</td>
<td>46.1</td>
<td>46.5</td>
</tr>
<tr>
<td>Year 4</td>
<td>42.6</td>
<td>41.9</td>
</tr>
<tr>
<td>Year 5</td>
<td>38.7</td>
<td>39.6</td>
</tr>
<tr>
<td>Thereafter</td>
<td>177.9</td>
<td>177.9</td>
</tr>
<tr>
<td>Total payments</td>
<td>420.3</td>
<td>425.0</td>
</tr>
</tbody>
</table>

Table 2

Calculation Of Operating Lease Adjustments For 2004

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt (reported)</td>
<td>659.4</td>
<td>664.9</td>
<td>766.8</td>
</tr>
<tr>
<td>Total interest (incl. capitalized interest)</td>
<td>36.2</td>
<td>40.2</td>
<td></td>
</tr>
<tr>
<td>Implied interest rate</td>
<td>5.5</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>Future minimum lease commitments (mil. $)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>61</td>
<td>65.8</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>54</td>
<td>53.3</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>46.1</td>
<td>46.5</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>42.6</td>
<td>41.9</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>38.7</td>
<td>39.6</td>
<td></td>
</tr>
<tr>
<td>2010 - 2014</td>
<td>38.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009 - 2012</td>
<td></td>
<td>39.6</td>
<td></td>
</tr>
<tr>
<td>Net present value (NPV)</td>
<td>336.5</td>
<td>318.7</td>
<td></td>
</tr>
<tr>
<td>2004 implicit interest</td>
<td>Avg. NPV ($327.6 x interest rate (5.5%) = $17.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease depreciation expense</td>
<td>Adjustment to SG&amp;A* - implicit interest = $63.4 - $17.9 = $45.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjustment to SG&amp;A — rent</td>
<td>Avg. first-year min. payments ($61.0 + $65.8)/2 = $63.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 2

<table>
<thead>
<tr>
<th>Calculation Of Operating Lease Adjustments For 2004 (cont.'d)</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
</table>
*SG&A — Selling, general, and administrative expenses.

Table 3

<table>
<thead>
<tr>
<th>Sample Calculation Results</th>
<th>Without capitalization</th>
<th>With capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oper. income/sales (%)</td>
<td>18.6</td>
<td>21.2</td>
</tr>
<tr>
<td>EBIT interest coverage (x)</td>
<td>8.7</td>
<td>6.2</td>
</tr>
<tr>
<td>EBITDA interest coverage (x)</td>
<td>12.3</td>
<td>8.6</td>
</tr>
<tr>
<td>Return on capital (%)</td>
<td>18.9</td>
<td>15.6</td>
</tr>
<tr>
<td>Funds from oper./total debt (%)</td>
<td>54.1</td>
<td>40.4</td>
</tr>
<tr>
<td>Total debt/EBITDA (x)</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Total debt/capital (%)</td>
<td>37.6</td>
<td>41.0</td>
</tr>
</tbody>
</table>

For the present value calculation, we generally use as the discount rate the issuer’s average interest rate (that is, interest expense/average debt outstanding) from the most recent annual statements, which is reflective of the issuer’s cost of borrowed funds. (For example, to derive the discount rate for adjusting 2004 financials, we will use 2004 interest expense divided by the average of year-end 2003 and year-end 2004 total debt.) Interest cost is adjusted to eliminate any distorting effects of capitalized interest, interest income, or derivatives-related gains/losses. (Also, if a company’s borrowing cost has soared because of financial distress, we avoid the perverse result of a seemingly shrinking lease obligation. In such a case, we will use the average of several years’ borrowing rates or a market ‘B’ rate, instead of the company’s average borrowing rate from the previous year.)

Ideally, we could use an even better alternative for the discount factor: the interest rates, or “money factors,” imputed in the company’s actual leases, upon inception. Another alternative might be the company’s average cost of secured debt. Where sufficient information is available and operating lease obligations are material, it is appropriate to use one of these bases instead. However, it is important for the sake of consistency that all companies in an industry peer group be adjusted in a consistent manner.

The resulting present-value figure is added to reported debt to calculate the total-debt-to-capital ratio. The figure also is added to assets to account for the right to use leased property over the lease term. Although less than the cost of the property, this adjustment recognizes that control of the property creates an economic asset.

The implicit interest is calculated by multiplying the average net present value at the end of the current and previous years by the rate used as the discount rate. This figure is then added to the company’s total interest expense. The SG&A adjustment is calculated by taking the average of the first-year minimum lease payments in the current and previous years. SG&A is then reduced by this amount. Depreciation expense is calculated by subtracting the implicit interest from the SG&A adjustment. The lease depreciation is then added to reported depreciation expense. The interest and depreciation adjustments attempt to allocate the annual rental cost of the operating leases. There is ultimately no change to reported net income as a result of applying the lease analytical methodology.
Financial ratio effect

- **EBIT**: The implicit lease depreciation adjustment is added to D&A expense; the adjustment to SG&A expense reduces SG&A expense. The result is to increase EBIT by the difference between the implicit lease depreciation and SG&A adjustments, or $17.9 million as shown in Table 2, which also is the amount of the implicit interest.

- **EBITDA**: In this case, only the implicit interest is added to EBITDA. The result is that EBITDA is increased $17.9 million. The rationale for not including implicit depreciation is that EBITDA is often used as a proxy for cash flow. However, rental expense is a cash expense, and it seems inappropriate to consider the entire rental expense as being available to pay interest. Moreover, EBITDA interest coverage, a key credit ratio, can be quite distorted by adding both implicit interest and depreciation to the numerator while adding only implicit interest to the denominator.

- **Interest expense**: The implicit interest figure, $17.9 million, is added to total interest expense.

- **Total debt**: The net present value of lease payments, $336.5 million, is added to total debt.

- **Operating income before D&A**: Standard & Poor’s typical calculation for the operating margin adds D&A back to operating income. When the operating lease adjustment is made, operating income is increased by the adjustment to SG&A expense, $63.4 million.

- **Funds from operations**: Funds from operations is increased by the implicit lease depreciation expense, $45.5 million—which is recharacterized as an increase in capital expenditures.

- **Capital expenditures**: The portion of the lease payment that represents the actual use of the asset—$45.5 million in our example—is added to capital expenditures, which reduces free cashflow by a like amount. Also, the increase in the net present value of lease payments from year to year is shown as an increase in capital spending—albeit without any effect on net cash. This adjustment highlights situations where a company is increasing its level of asset leasing—presumably in lieu of conventional spending. Without such an adjustment, we might mistakenly conclude, for example, that the company was underspending for its capital equipment needs. (Since factors other than new lease take-up can lead to that increase—such as changes in foreign exchange rates or the implicit rate used in calculating the net present value—we would try to be mindful of what was actually occurring.)

Limitations Of The Model

Analysts and investors need to be aware of the limitations of our model. In many cases, our computed lease-related debt is significantly understated. We base our capitalization of the lease obligation on the disclosed stream of minimum future rental payments, even when we expect contingent payments to increase actual rental expense significantly above the minimums. Also, by basing our calculation of the liability on the minimum future lease payments, we effectively carve out any consideration of indirect residual risk because, under FAS 13, if the present value of the minimum lease payments is 90% or more of the fair value of the asset, the lease is not classified as an operating lease—but as a capital lease. So at least 10% of the asset value gets overlooked. (If, however, a company extends a residual guarantee for assets under operating leases, this should be reflected in our analysis as a debt equivalent.) IFRS accounting poses similar issues of understatement.

More broadly, our adjustment model does NOT seek to replicate a scenario in which a company acquired an asset and financed it with debt; rather, our adjustment is narrower in scope: it attempts to capture only the debt-equivalent of a company’s lease contracts in place. Whenever a company leases for five years an asset with a 20-year productive life, the adjustment picks up only the lease period, ignoring the cost of the entire asset that would have been purchased—and depreciated—by a company that chose to buy instead of lease.
Alternate methodologies (known as factor methods) attempt to replicate a debt-financed purchase of the operating asset. The conceptual advantages of these methodologies—especially in terms of comparing companies—are limited by other analytical shortcomings and considerations. The factor methods use multiples of annual expense to estimate the asset value—typically in a crude or arbitrary fashion. Also, while incorporating the equivalent of owning the entire asset, these methodologies lack the ability to differentiate between the first year of the asset’s life, the last year, and all points in between. (An asset actually purchased would be depreciated over its life.) And, by putting leasing and ownership on a supposed ‘apples-to-apples’ basis, they gloss over the potential flexibility associated with leasing only part of an asset’s economic life.

Given the alternatives, we prefer our current, present-value methodology. However, there could be merit in using more than one method to capture leasing activity—especially if some of the problems with the ‘factor methods’ can be addressed. We intend to explore the possibility of introducing a methodology that is more comprehensive (i.e., which would replicate a full asset purchase) to supplement the current methodology.
Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project

On July 19, 2006, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) formally added a ‘major project’ to their respective agendas to reconsider current lease accounting standards. The project is intended to be a comprehensive revisit of the FASB’s long-standing lease-accounting rules, provided predominantly by the Statement of Financial Accounting Standards No. 13, Accounting for Leases (Statement No. 13)—which have been in place for three decades, and International Accounting Standard 17, Leases (IAS 17), issued in 1982. These standards provide an ‘all-or-nothing’ approach to lease accounting in that a lease is either accounted for as capital or operating. This approach has been considered problematic by many because of its failure to accurately portray the benefits and obligations that arise from various leasing arrangements. The project is expected to commence early in 2007, and is expected to lead initially to the publication of a joint discussion paper in 2008. The timing for issuance of a new lease-accounting standard is not yet determinable.

Standard & Poor’s Ratings Services has long viewed the accounting distinction between operating and capital leases as substantially artificial. As a result of this, we apply an adjustment methodology intended to eliminate that distinction by capitalizing lease obligations accounted for as operating leases. This enhances comparability of reported results and obligations among rated issuers, including those that use debt to finance asset acquisitions. (See Standard & Poor’s “Corporate Ratings Criteria – 2006”, available at www.corporatecriteria.standardandpoors.com, and on RatingsDirect, the real-time Web-based source for Standard & Poor’s credit ratings, research, and risk analysis.)

We support the decision by the FASB and the IASB to reconsider lease-accounting standards. There have been published comments from current FASB board members suggesting that the focus will no longer be on the ownership of the asset and the party that should have the leased property on
its books, but rather on the right to use the asset as conveyed by the lease terms, which appears to be more closely aligned with our methodology. We currently believe any new standard that ultimately is adopted will involve the recording of most, if not all, leases on the lessee’s balance sheet. However, it is very early in the process, and too soon to determine the ultimate course the project may take.

As our current analytical focus on lease obligations considers the variety of related financial and business risks, we currently believe the ultimate changes to lease-accounting standards are unlikely to result in a vast, or direct, impact on our ratings for issuers— notwithstanding their potential to meaningfully increase reported leverage. Yet, as discussed below, rating consequences may still arise. Accordingly, we intend to closely follow the progress of the project and consider its ultimate impact on issuers rated by Standard & Poor’s as more details come to light.

Why The Leasing Project Is Being Added

Since the issuance of Statement No. 13, modifications were limited to interpreting the standard, the recent addition of disclosure requirements related to off-balance sheet arrangements, and the measurement and disclosure of guarantees embedded in a lease agreement (e.g., guarantees of the residual value of the leased asset at lease expiry). In fact, because of the vast complexity and unique nature of lease accounting, leases were specifically exempted from many recently issued and proposed financial standards. Thus, over time, market developments have outpaced the corresponding updates to the lease-accounting model, further exposing the flaws in the current model.

Chief among the concerns expected to be addressed by the new standard is the off-balance sheet treatment under existing standards of operating lease transactions. The accounting for leases distinguishes between operating and finance leases, whereas finance leases (also referred to as capital leases) are accounted for essentially in a manner similar to a debt-financed acquisition of an asset, while operating leases are reflected in the accounts on a pay-as-you-go basis, which is subject to straight-lining if the lease payments’ pattern differs from the pattern of the leased asset utilization. We—and many other users of financial statements—view the accounting distinction between operating and capital leases as substantially artificial, because in both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments (see table 1 for an overview of the governing criteria for lease classification under U.S. GAAP and IFRS).

Many constituents also view the current lease-accounting standards as too complex. The hundreds of lease restatements that occurred, primarily in the U.S. retail industry, during the 2005 SEC filing season lends support to the notion of the complexity of lease accounting and the need for change in the prominent use of bright line tests. (See “Lease Accounting Restatements Unlikely To Affect U.S. Retail Industry Ratings,” March 22, 2005, and “Analytical Considerations Of Operating Leases In U.S. Retail,” November 29, 2005, published on RatingsDirect.)

Besides the clamor for change by some financial statement users, the addition of this project to the FASB’s agenda has been widely anticipated since the SEC staff issued its June 2005 report on off-balance sheet arrangements*. In this report, the SEC took issue with what it termed the all-or-nothing approach resulting from applying the bright line tests of the existing lease accounting rules, as well as the resultant structuring of transactions to pass these tests and obtain off-balance sheet treatment (see table 2). The SEC’s study estimated
that there are approximately $1.25 trillion in undiscounted, noncancelable future cash obligations committed under operating lease arrangements that are disclosed but not recognized on issuers’ balance sheets. As a result of its study, the SEC recommended that the FASB revisit lease accounting.

Serious thoughts of changing lease accounting standards under Statement No. 13 date well before the SEC’s recommendation, back at least to the mid-1990s, when a group of accounting standard setters, known as G4+1, pointed out deficiencies and proposed an alternative approach. The G4+1 group consisted of members of the FASB, the IASB (in its past incarnation as the International Accounting Standards Committee), and the Australian, Canadian, and U.K. accounting standard-setting boards. The group’s studies culminated in the issuance of two special reports, the first issued in 1996 and the second in 2000. These papers may very well provide a roadmap as to the future direction of the current lease project (see table 3).

Issues with the current lease accounting standards go well beyond the question of the off-balance sheet nature of operating leases. For example, as leasing arrangements have become more complex, the lines have blurred and there has been a rethinking as to what a lease really is, for example, whether certain types of long-term purchase commitments are leases. In May 2003, the FASB ratified a consensus reached by the Emerging Issues Task Force (EITF) EITF Issue 01-8—Determining Whether an Arrangement Contains a Lease, which was intended to address these issues. However EITF 01-8, as well as its international equivalent, Interpretation 4 of the International Financial Reporting Interpretations Committee (IFRIC4), did not resolve many of the open issues in this gray area, which remain to be addressed as part of the comprehensive revisit.

These types of complex issues, in addition to issues such as the treatment of renewal, cancellation and purchase options, as well as the treatment of contingent rentals, to name only a few, will need to be reconsidered within the new lease accounting framework.

**What Likely Will Change**

The FASB’s stated objective in convening the joint project is to comprehensively reconsider existing lease accounting standards, in order to ensure that financial statement users are provided useful, transparent, and complete information about leasing transactions in the financial statements. The FASB, as have many of its constituents, has come to the conclusion that the 30-year old requirements under Statement No. 13 no longer provide such usefulness and transparency, because leasing transactions have evolved in both size and complexity during that period. The project scope includes a broad reconsideration of existing standards of accounting for both lessees and lessors.

While it is too early to speculate on the specifics of a new lease-accounting framework, we believe it will involve some methodology of recording assets and liabilities arising from leasing arrangement and bringing many lease transactions that are currently treated as operating leases (in whole or in part) on the lessees’ balance sheet. Estimates are that such a requirement would add hundreds of billions of dollars to corporate balance sheets. Also, while current FASB standards in particular are rules-based, leading to varying accounting treatment for substantially similar transactions, it is anticipated that the new joint standard will be considerably more principles-based.
The project also will consider revisions to the accounting for leases by lessors, which has not always been symmetric to that of the lessee. For example, a lessee may record an operating lease, thereby not recording any assets or liabilities arising from the lease on its books, while the lessor in the same transaction may record a ‘sales-type’ or a ‘finance’ lease and accordingly, will remove the leased asset and obligations from its books.

Further, there are other unique aspects of leasing arrangements likely to be reconsidered in this project; as a result, the accounting likely will change vastly. These include leveraged leases, sale and leaseback transactions, and long-term supply or purchase agreements that may encompass certain lease-like characteristics (e.g., power purchase and long-term supply contracts).

It is unlikely that a new accounting standard would be issued in 2009, and in fact the issuance may occur much later. However, it is important to note that the IASB recently announced a decision not to require the application of any new standards under development or major amendments to existing standards before Jan. 1, 2009. While not specified, it is possible the FASB will consider a two-phase approach, such as it currently is using for its projects on liabilities and equity, and pensions and other postretirement obligations. To assist in the development of this complex standard, the boards intend to convene a joint international working group (composed of financial statement preparers, lessors and lessees, auditors, investors, analysts, and other users of financial statements) to provide input on proposals and on issues to be considered.

**Ratings Are Not Expected To Materially Change**

To compensate for some of the perceived accounting deficiencies, we have been adjusting corporate issuers’ financial statements for many years—principally by capitalizing the net present value of disclosed future minimum lease payment commitments and by adjusting other profitability and cash-flow measures utilized in our analysis (see Standard & Poor’s “CreditStats—Operating Lease Analytical Model,” published April 5, 2005, and “CreditStats: Standard & Poor’s Revises Statistical Practices,” published May 15, 2006, on RatingsDirect, for a detailed discussion of our methodology and the measures being adjusted).

Although our practice already attributes additional debt for operating leases, the amounts derived from applying our methodology are based on estimates and assumptions and undoubtedly will differ from the amounts that will be recognized under any new lease accounting rules, both because of estimation and potentially conceptual differences in what the capitalized amount would represent (e.g., the incorporation of contingent rental payments in the present-value calculation). In addition, our existing model does not seek to fully replicate a scenario in which a company acquired an asset and financed it with debt; rather, our adjustment is narrower in scope. It attempts to capture only the debt-equivalent of a company’s lease contracts in place (e.g., the adjustment picks up only the lease period and ignores the cost of the entire asset that would have been purchased). Thus, our methodology currently may capitalize a smaller amount than might occur under new accounting rules treating the transaction as a full purchase of the asset. Notwithstanding these measurement issues, we do not currently envision that there will be a material impact to our issuer ratings merely as a result of adding these obligations to the balance sheet, unless the nature of the lease arrangements or their monetary significance were not sufficiently disclosed or otherwise available to Standard & Poor’s analysts.

However, important rating considerations, with the potential for ratings changes, could still arise because of the following (if they influence significant changes in business or financial risk factors):
• Covenant and regulatory compliance matters;
• Adverse market reaction; and
• Changes in business practices.

Assuming the envisioned new accounting standard for transactions currently accounted for as operating leases would add both an asset and a liability to the lessee’s balance sheet, there should not be a significant change to equity as a result of applying the new standard at lease inception, and potentially not a significant change to equity as a result of retrospective application (as the depreciation on the lease asset likely will be matched by the presumed ‘principal’ reduction on the hypothetical debt). However, for some of our rated issuers, there will be a large increase to reported leverage. This could adversely affect compliance with debt covenants, which may need to be renegotiated to avoid triggering solely on the addition of the operating lease liability. There may also be regulatory implications for some companies as a result of having to add additional debt to their balance sheets. Further, because of the apparent increased leverage, there could also be adverse market reactions resulting in potentially increased cost of capital and in extreme cases, potential challenges in accessing equity or debt financing.

Another important area will be the potential for changes in behavior and business practices that such lease accounting changes may cause. If off-balance sheet treatment is denied, many companies may lose one of their incentives for leasing instead of buying; we thus could see a large reduction in the number of leasing transactions, or at least a change in the way lease contracts are structured or negotiated. Changes in business practices would affect lessee- as well as lessor-issuers, and issuers in the business of providing services to the lease structuring industry (e.g., residual value guarantors). In addition, the appeal of certain structured transactions may diminish, resulting in modification to existing and future structured and project financing transactions. Further, depending on the direction the ultimate project is taking, other parties to other long-term contracts not currently considered leases (e.g., power purchase contracts, long-term service contracts, data center technology outsourcing, etc.) could be affected as well.

Although we expect the interest in, and volume of, certain leasing transactions may decline as a result of the potential accounting change, we do not expect the traditional operating lease structure to disappear. In fact, we believe the use of leasing will remain quite common. It is important to note that many leases are entered into without regard to financial reporting objectives or where the financial reporting benefit is not the primary objective. Companies often will lease to achieve efficient and cost-effective access to variety of capital sources, reduce residual risk, achieve flexibility with asset replacement, and for tax efficiency reasons.

While the recent addition of the lease project has received much attention, we realize that we are still at least three years away from the issuance of a new standard. The issues to be deliberated by the boards are not trivial, and we expect to see significant interest and potentially divergent views expressed by many constituencies including companies, their auditors, analysts, investors, regulators, and industry and trade associations. Accordingly, we will continue to closely monitor the project’s development and assess the implications on the aforementioned attributes on companies rated by Standard & Poor’s.
Table 1

**Current Lease-Accounting Standards**

Statement of Financial Accounting Standards No. 13, Accounting for Leases, provides the foundation for current U.S. GAAP lease accounting standards. The statement was issued in 1976 and provides for the accounting treatment by both lessees and lessors. Current lease-accounting standards are rules-based and focus on a determination as to which party to a lease agreement has the risks and rewards of ownership of the leased asset. The underlying concept is that where a lease transfers substantially all of the benefits and risks of ownership, the lease should be treated as an acquisition of an asset and incurrence of a liability by the lessee (capital lease treatment) and as a sale or financing by the lessor (sales-type, direct financing or leveraged lease). When this is not the case, the lease should be treated as the rental of property (operating lease treatment). Thus, capital leases are treated as debt-financed purchases and included on-balance sheet, while operating leases are treated as rentals and remain off-balance sheet.

Statement No. 13 provides so called bright-line tests to determine the appropriate lease-accounting classification. However, the existence of these tests allows companies to structure their leases in order to ensure operating lease treatment, thus keeping the transaction off-balance sheet, with only footnote disclosure of the future obligations. A company that structures a lease to have a present value of minimum lease payments of 89.9% of an asset’s value could receive operating lease treatment, while another company with 90% could receive totally different accounting treatment as a capital lease.

The criteria for classifying a lease as either operating or finance under IAS 17, although less detailed than U.S. GAAP and more principles-based, provides for substantially similar distinction between operating and finance leases (see tables 1-A to 1-C, below). Other notable differences include the treatment of third-party guarantees related to the leased assets which are included in minimum lease payments under IAS 17 and excluded under Statement No. 13, the recognition of a gain on a sale and leaseback transaction where the leaseback is an operating lease which is recognized immediately under IAS 17 and amortized over the lease term under Statement No. 13. Lease classification determination is generally determined at lease inception and is only changed if the lease agreement is modified by the parties.
Table 1-A

**Lease Classification Tests - Statement No. 13**

**Lessee**

A lease is classified as a capital lease if, at inception, the lease meets one or more of the following four criteria:

— The lease transfers ownership of the property to the lessee by the end of the lease term.

— The lease contains a bargain purchase option.

— The lease term is equal to 75% or more of the estimated economic life of the leased property.

— The present value at the beginning of the lease term of the minimum lease payments is 90% or more of the fair value of the leased property to the lessor at the inception of the lease.

A lease not meeting one or more of the above criteria is classified as an operating lease.

**Lessor**

A lessor will classify a lease as either a sales-type lease or a direct financing lease, as appropriate, if at inception, the lease meets any one of the four criteria listed above for capital lease treatment by lessees, and in addition, meets both of the following criteria:

— Collectibility of the minimum lease payments is reasonably predictable, and

— No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

In addition to sales-type leases and direct financing leases, Statement No. 13 provides accounting guidance for leveraged leases, which are direct financing leases that meet certain other qualifying criteria. If these criteria are met, a lessor can net a non-recourse debt obligation from the lease balance on the balance sheet.

Any lease which is not classified as a sales-type, direct financing or leveraged lease is classified as an operating lease.

Table 1-B

**Lease Classification Tests - IAS 17**

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset (title to the leased property may or may not eventually be transferred).

An operating lease is a lease other than a finance lease.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

IAS 17 provides examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease. These examples are:

— The lease transfers ownership of the asset to the lessee by the end of the lease term.

— The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

— The lease term is for the major part of the economic life of the asset even if title is not transferred.

— At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

— The leased assets are of such a specialized nature that only the lessee can use them without major modifications.

Other indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease include:

— If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

— The gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease).

— The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
### Accounting Treatment - Statement No. 13 and IAS 17

#### Capital Lease Treatment

<table>
<thead>
<tr>
<th><strong>Lessee</strong></th>
<th><strong>Balance Sheet:</strong> Capital leases are recorded as assets and liabilities at the lower of the present value (at the beginning of the lease term) of the minimum lease payments during the lease term or the fair value of the leased property at the inception date.</th>
<th><strong>Income Statement:</strong> Depreciation and interest expense are recorded.</th>
<th><strong>Cash Flow Statement:</strong> Payments are allocated to principal and interest, with principal categorized as financing cash flows and interest as operating under U.S. GAAP, and operating or financing under IFRS. Depreciation of the leased asset is adjusted in arriving at operating cash flows.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lessor</strong></td>
<td><strong>Balance Sheet:</strong> Removes the cost of the asset from its balance sheet and records a gross investment in the lease based on the present value of the minimum lease payments plus the unguaranteed residual value.</td>
<td><strong>Income Statement:</strong> Finance income is recognized over the lease term using the interest method. For a sales-type lease, gain on sale is recorded at inception.</td>
<td><strong>Cash Flow Statement:</strong> Financing income received is categorized as operating cash flows. Principal payments received are categorized as investing cash flows.</td>
</tr>
</tbody>
</table>

#### Operating Lease Treatment

<table>
<thead>
<tr>
<th><strong>Lessee</strong></th>
<th><strong>Balance Sheet:</strong> No asset or liability is recorded on the balance sheet.</th>
<th><strong>Income Statement:</strong> Lease rental expense is generally deducted on a straight-line basis over the lease term.</th>
<th><strong>Cash Flow Statement:</strong> Rental payments are categorized as operating cash flows.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lessor</strong></td>
<td><strong>Balance Sheet:</strong> Retains the asset on its balance sheet.</td>
<td><strong>Income Statement:</strong> Records both lease rental income and depreciation expense.</td>
<td><strong>Cash Flow Statement:</strong> Lease rental payments are categorized as operating cash flows. Depreciation is adjusted in arriving at operating cash flows.</td>
</tr>
</tbody>
</table>
Table 2

The SEC’s Views On Lease Accounting*

*... We concentrate on the case where an issuer is the lessee, that is, where the issuer is the party using the asset, as this is the scenario most likely to result in no elements of the lease or leased asset being on the balance sheet. Leases can transfer control of the asset from the lessor to the lessee for as much of the asset’s life as desired, and can also transfer as many of the risks and rewards of ownership as desired. Leasing transactions can take many forms and include many different terms. Yet, despite this diversity in leasing arrangements, all leases receive one of two opposing accounting treatments; either the lease is treated as if it were a sale or as if it were a rental... *

*... The lease accounting guidance either treats the contract as if all of the performance occurs at the beginning of the lease, or as if none of it does. The intention is to treat those leases that are economically equivalent to sales as sales, and to treat other leases similar to service contracts. This approach, while a significant improvement from previous lease accounting, which rarely if ever required recognition of a capital lease, does not allow the balance sheet to show the fact that, in just about every lease, both parties have some interest in the asset, as well as some interest in one or more financial receivables or payables... *

*... For example, when the FASB issued a standard in 1976 that required some lease obligations to be recorded on the balance sheet as liabilities, many lessees immediately began to restructure their leases to avoid recognizing liabilities. Their efforts were aided by parties who sought to profit from offering their expertise in structuring leases in ways that provided “preferable” accounting. Such structuring tends to reduce transparency... *

In 1996, the G4+1 issued the first of two special reports on lease accounting, “Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities Arising Under Lease Contracts,” which discussed the perceived deficiencies in existing lease accounting standards and took a new conceptual approach focusing on the fundamental components of lease transactions, principally in regard to accounting by lessees. This paper found that the primary deficiency of current lease accounting standards was that it allowed lessees off-balance sheet treatment of material assets and liabilities arising from operating leases.

Also highlighted was the fact that structuring transactions were effectively allowing transactions that were essentially capital in nature to be accounted for as off-balance sheet operating leases. The paper recommended a new approach with no distinction between capital leases and operating leases. The approach focuses on economic rights and obligations, as opposed to the concepts of legal ownership and legal obligations, and would result in a more likely recognition of assets and liabilities under operating leases.

In 2000, the G4+1 released its second special report, “Leases: Implementation of a New Approach” for public comment. Building on the first report’s work on the conceptual foundation for revised lease accounting standards, this report presented recommendations for how the conceptual approach might be implemented. It was also more comprehensive with respect to accounting by lessors.

As to accounting by lessees, the report recommended that the fair value of the rights and obligations that are conveyed by the lease should be recorded at inception of the lease. Fair value would be measured based on the consideration given by the lessee, including any liabilities incurred except where the fair value of the leased property received is more evident of fair value. Fair value could not be less than the present value of the minimum lease payments. For leases currently classified as operating leases, this recommendation would result in the recording of on-balance sheet assets and liabilities.

The report also includes recommendations as to the lessee’s treatment of leases with optional features such as rights of renewal, cancellation, and purchase options, as well as contingent rentals. Among the recommendations in this area is that the exercise of renewal or purchase options should generally not be anticipated, with the fair value of the options being reflected in the minimum lease payments under the lease. When renewal and purchase options are exercised, additional assets and liabilities would be recorded for the additional rights and obligations given to the lessee. Contingent rentals should be recognized when the contingency criteria are met.

As to accounting by lessors, the report includes a recommendation that gain should be recognized by a lessor at the inception of the lease if there is evidence that the value of the lessor’s net assets has increased by entering into the lease and such gain can be reliably measured. Also, with regard to lease options and contingent rentals from the lessor’s viewpoint, the report presumes that where a lease contract gives rise to a lessee liability, it should also give rise to an asset for the lessor.

The report gives further recommendations on the treatment for both lessees and lessors on other leasing issues, including residual values, sale and leaseback transactions, and discount rates used.

Footnotes:

*United States Securities and Exchange Commission—Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.

While the SEC study cited $1.25 trillion in undiscounted cash flows under operating lease obligations, it did not attempt to provide an actual estimate of the amount that would be reported on balance sheets. However, for illustrative purposes, it provided that the discounted value of a series of five (or ten) equal annual cash flows, using an 8% discount rate, would be approximately 80% (or 67%) of the $1.25 trillion in undiscounted cash flows.
The Rating Agencies’ Perspective on Leasing and Lease Accounting

Moderator:
Mindy Berman (42 North Structured Finance, Inc.)

Presenters / Panelists:
Neri Bukspan (Standard & Poor’s Ratings Services)
Mark LaMonte (Moody’s Investors Service)
Agenda

• Introductory remarks…
  – Overview of Rating Agency role
  – How financial information is used in the rating process
  – Overview of analytic adjustments to financial statements
  – Detailed review of analytic adjustments for operating leases
  – Proposed changes to lease accounting

• Panel discussion
Overview of Rating Agency Role

- Moody’s and S&P both rate in excess of 150,000 individual corporate, government and structured finance securities
- Moody’s and S&P each have ratings on in excess of $34 trillion of outstanding debt
Overview of Rating Agency Role

Uses of Credit Ratings

- Building Portfolios
- Pricing
- Contracts
- Trading

Regulatory Requirements
Overview of Rating Agency Role

Benefits of Ratings for Companies...

• Market access (gate keeping)
• Expands breadth of market
• Widens distribution
• Improves liquidity
• Improves pricing
• Helps management with independent, outside perspective on company
• Helps management monitor counterparty risk
Overview of Rating Agency Role

Benefits of Ratings for Investors…

• Due diligence efficiency
• Multiple independent perspectives
• Facilitates comparisons
• Tool in portfolio management
• Enhances secondary market liquidity
• Relatively stable over time
• Basis for performance benchmarks
Use of Financial Information in the Rating Process

- Issue Structure
- Company Structure
- Operating / Financial Position
- Management Quality
- Industry / Regulatory Trends
- Sovereign / Macro Economic

Financial Reporting

Severity of Loss

Probability of Default

Equipment Leasing Association (ELA)
Use of Financial Information in the Rating Process

1. Adjust Data
2. Compute key data & ratios
3. Compare with peers
4. Identify trends
5. Project financial data
6. Stress test projections

Data Sources:
- Financial Statement Data
- Other Company Specific Data
- Industry / Macro Economic Data

Equipment Leasing Association (ELA)
S&P Adjustments to Financial Statements

• Financial statements are not necessarily viewed as “truth” – i.e., as the optimal depiction of the economic reality of the issuer’s financial performance and position.
• Our financial analysis process necessitates making certain analytical adjustments to financial statements to arrive at measures that:
  I. Enable more meaningful peer and period-over-period comparisons;
  II. Better reflect underlying economics;
  III. Better reflect creditors’ risks, rights, and benefits; and
  IV. Facilitate more robust financial forecasts.
Why We Adjust

- Adjusting financials long has been our practice -- it is an integral part of the rating process.
- Although we revise certain amounts reported under applicable GAAP, that does not imply that we challenge:
  - The application of GAAP by the issuer;
  - The adequacy of its audit or financial reporting process; or
  - The appropriateness of GAAP accounting to fairly depict the issuer’s financial position and results for other purposes.
- Rather, it reflects a fundamental difference between accounting and analysis; the accountant necessarily must find one number to use in presenting financial data: The analyst, by definition, picks apart the numbers.
- Good analysis looks at multiple perspectives and uses adjustments as an analytical technique to depict a situation differently for a specific purpose, or to gain another vantage point(s).
Why We Adjust (Cont.)

• The (adjusted) financial measures serve as a baseline for a much broader analytic process, in which we consider myriad other financial and nonfinancial factors (both qualitative and quantitative).

• These include (to name only a few):
  – Economic, regulatory, and geopolitical influences;
  – Management and corporate-governance attributes;
  – Key performance indicators;
  – Financing and liquidity means;
  – Competitive trends;
  – Product-mix considerations;
  – R&D prospects;
  – Patents rights; and
  – Labor relations.

• To that end, supplementary interpretive nonfinancial and trend data are essential (e.g., information provided in the MD&A, and data gathered from our discussions with issuers and other experts).
Analyzing Leasing Arrangements

• The most important point to consider is that leasing is a form of financing!

• We consider the appropriateness of using lease financing in connection with our evaluation of overall capitalization and asset acquisition objectives – and also whether leases are being used to avoid reporting key assets and liabilities.

• Like any other form of financing, leasing has a claim on future cash flows.

• Leases also can give rise to other assets and liabilities with significance to our analysis (including contingent assets or liabilities – such as guarantees and purchase options).
Analyzing Leasing Arrangements (Cont.)

- The analysis must consider covenants (both lease covenants and their impact on other debt covenants), and the recourse or nonrecourse nature of the lease.
- Lessees do not own the leased assets, and leased assets are not available to satisfy claims of the company’s other creditors (in most cases).
- Accounting rules often distort the picture – requiring a recasting of financial information and careful reading of footnotes and MD&A disclosures.
- We do not forget that there are many positive attributes to leasing (e.g., flexibility, tax advantages, and effective all-in cost).
Analytical Considerations

- Lease term (contractual or implied).
- Payments and payment base (e.g., fixed, contingent, CPI-, or LIBOR-based).
- Escalation provisions or rent holidays.
- Purchase options.
- Renewal and early termination options or obligations.
- Residual value guarantees.
- Who pays for executory costs (e.g., insurance, taxes, maintenance, AROs).
- Default provisions/triggers and cross default provisions.
- Economic penalties (which can extend terms, and/or increase costs or reduce flexibility).
We view the distinction between operating and capital leases as artificial.

Our lease adjustments seek to enhance comparability of reported results (both operating and financial), and financial obligations among companies.

The adjustment model is intended to make companies' financial ratios closer to the underlying economics and more comparable, by taking into consideration all financial obligations incurred, whether on or off the balance sheet.

The model also helps improve analysis of how profitably a company employs both its leased and owned assets.
Balance Sheet & Capital Structure Analysis

• We adjust leverage and capitalization measures to include operating lease-related obligations as follows:
  – We capitalize the present value of lease commitments (based on information obtained from the notes), which is treated as additional financial obligation.
  – We generally use the average interest rate as the discount rate (i.e., interest expense/average debt) from the most recent financials.
  – The resulting present-value figure is added to reported debt (as for finance/capital leases) – included to calculate the total-debt-to-capital and other leverage ratios.
  – The figure also is added to assets to account for the right to use the leased property over the lease term (although less than the cost of the property, this adjustment recognizes that control of the property creates an economic asset).
  – The required lease payments generally are taken gross, rather than netting out sublease income; but, when the head lease and the sublease are matched and the counterparty is sufficiently creditworthy, we would use net payments.
Profitability Analysis

• Rental expense associated with operating leases is reversed.
• The amount is then allocated to interest and depreciation.
• The interest and depreciation adjustments attempt to apportion the periodic cost in a manner akin to debt-financed asset acquisition as follows:
  – We adjust SG&A expenses by adding back the annual expense.
  – The implicit interest cost is calculated by multiplying the average net present value at the end of the current and previous years by the rate used as the discount rate. This figure is added to total interest expense.
  – The lease depreciation is added to reported depreciation expense.
  – The depreciation adjustment is arrived at using a residual calculation by subtracting the implicit interest expense from the annual expense.
  – There is ultimately no change to reported net income as a result of applying the lease analytical methodology.
Cash Flow Analysis

- FFO is increased by the implicit lease depreciation amount.
- The implicit depreciation plus the increase in the net present value of lease payments from year to year is considered as an increase in capital spending (albeit without any corresponding effect on net cash).
- Free cash flow is reduced by the same amount -- this adjustment highlights situations where a company is increasing its level of asset leasing, presumably in lieu of conventional spending.
- Operating lease payments generally are recognized in earnings on a straight-line basis over the lease term, independent of actual cash payments (which might fluctuate, for example, as a result of rent holidays or other incentives). Since this pattern of recognition of expense conforms to the underlying economics of the arrangement (and in most cases adjustments are impractical), we generally do not adjust reported FFO or EBITDA for the difference.
- In calculating cash flows related measures (e.g., EBITDA/Interest) only the implicit interest is added to EBITDA -- the rationale for not including implicit depreciation is that EBITDA is often used as a proxy for cash flow. However, rental expense is a cash expense, and we view it as inappropriate to consider the entire rental expense as being available to pay interest.
Additional Considerations

There are certain inherent limitations to the model:

• In many cases, the computed lease-related debt is significantly understated, because we base our capitalization on the disclosed stream of minimum future rental payments, even when we expect substantial contingent payments; however, in cases where contingent payments are expected to be substantial, we note that the net present value (NVP) adjustments significantly understate the economic commitment and, as a consequence, future cash flows.

• However, contingent rentals are taken into account in computing FFO and EBITDA (i.e., these measures include contingent rental amounts).

• By basing our calculation on the minimum future lease payments, we effectively carve out any consideration of indirect residual risk because under U.S GAAP, if the PV of the minimum payments is 90% or more of the fair value of the asset, the lease is classified as a capital lease. So for operating leases, at least 10% of the value gets overlooked. (A substantially similar outcome will arise under IFRS.)
• Broadly, our model does not seek to fully replicate a scenario in which an asset is acquired with debt.
• Rather, our adjustment is narrower in scope—it attempts to capture only the debt-equivalent of lease contracts in place.
• For example, whenever a company leases for five years an asset with a 20-year productive life, the adjustment picks up only the lease period, ignoring the cost of the entire asset that would have been purchased—and depreciated by an entity that chose to buy instead of lease.
• Although both U.S. GAAP and IFRS require disclosure of future lease commitments—data often are not available under other GAAP. In these cases, we will use a multiple of the last annual rental expense to approximate the obligation.
• We also treat capital leases as a debt-financed acquisition of an asset: As such, to the extent the cap-ex measure is of analytical significance, we increase the cap-ex measure by that amount.
Moody’s Approach to Adjusting for Operating Leases

Rationale for Moody’s Adjustments

What are we trying to achieve?  
- Comparability

What do we want to know?  
- Value of leased assets because Assets = Debt

What do we know?  
- Current and Future Lease Commitments

Our analytic goal is to simulate a company’s financial statements assuming it had bought and depreciated the leased assets, and financed the purchase with a like amount of debt.
Moody’s Approach to Adjusting for Operating Leases

Impact on Financial Statements

• Balance Sheet:
  – Apply a multiple to rent expense to calculate the amount of the adjustment to debt / fixed assets
  – Standard PV of disclosed lease commitments will serve as a floor

• Income Statement:
  – Uses market convention to allocate interest and depreciation components of rent expense → 1/3 interest | 2/3 depreciation
Moody’s Approach to Adjusting for Operating Leases

Impact on Financial Statements

- **Cash Flow Statement:**
  - Adjust depreciation line item in the *Operating* section of the cash flow statement for the depreciation component of rent expense.
  - Increase CAPEX in the *Investing* section of the cash flow statement by the depreciation component of rent expense.
  - Off-setting cash in-flow for new borrowing and cash out-flow for principal repayment component of rent expense in the *Financing* section of the cash flow statement.

*Consistent with view that lease obligations are “debt-like”... but adjustment is cash flow neutral at the Free Cash Flow level*
Moody’s Approach to Adjusting for Operating Leases

Moody’s Use of a Rent Multiple

• Three approaches were considered…
  – Present value of disclosed commitments
  – “Modified Present Value” (MPV)
  – Multiple applied to rent expense

• We settled on the use of a multiple approach because…
  – It’s simple, transparent and replicable by outsiders
  – It allows us to achieve our objective – comparability – without
    the level of complexity inherent in the MPV approach
  – Required public disclosures generally provide sufficient
    information to calculate our adjustment
Moody’s Approach to Adjusting for Operating Leases

How does the rent multiple relate to the MPV concept?

PPE = Debt

Rent = ?
Rent = Interest + Depreciation
Rent = PPE x Int Rate + PPE / Useful Life
Rent = PPE x (Int Rate + 1/Useful Life)
PPE = Rent / (Int Rate + 1/Useful Life)

The “Rent Multiple” in Moody’s lease adjustment is based on the above formula applied to $1 of rent...

Multiple = $1 / (Int Rate + 1/Useful Life)

To simulate the depreciated amount of the asset, we assume 60% of the useful life remains.
Moody’s Approach to Adjusting for Operating Leases

How does the rent multiple relate to the MPV concept?

<table>
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<tr>
<th>Interest Rate Inherent in the Lease Portfolio (or Incremental LT Borrowing Rate)</th>
<th>12%</th>
<th>11%</th>
<th>10%</th>
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After 60% Factor → 3 4 5 7 9 12 15 18 21 24
Full Useful Life → 5 7 9 12 15 20 25 30 35 40

Estimated Weighted Average Original Useful Life of Leased Assets

Equipment Leasing Association
Moody’s Approach to Adjusting for Operating Leases

Standard Rent Multiples for Peer Groups

• Rent multiples are set for each peer group (based on the 48 broad industry classifications)
  – Teams selected among four multiples… 5X, 6X, 8X and 10X
  – Selection of peer group multiples was consistent with MPV methodology → both theory and application
  – Selected multiple is generally used for all companies in the peer group
  – A different multiple can be used (with Rating Committee approval) if unique facts and circumstances warrant
Proposed Changes to Lease Accounting

• On FASB’s & IASB’s joint agenda—catalyzed by the SEC’s views expressed in its report on “off-balance sheet arrangements” (according to the SEC approximately $1.25 trillion in non cancelable future operating lease commitments are disclosed and are off-balance sheet).

• S&P strongly supports the addition of a comprehensive lease accounting project:
  – Lease accounting is incongruent with other standards.
  – Clarity is needed for the accounting for lease-like arrangements.
  – Disclosures are improving but still lacking—especially for non-SEC registrants and foreign companies not reporting under IFRS.
  – International convergence and greater consistency among issuers would be beneficial to analysts.
Will Ratings Change?

• Because we have been adjusting and considered operating leases in our analysis all along, we do not expect ratings to materially change as a result of a lease accounting change.

• Although we already attribute additional debt for operating leases, the amounts derived from applying our methodology are based on estimates and assumptions which undoubtedly will differ from those that would be recognized under any new lease accounting rules.

• This difference will result because of estimation, and potentially, conceptual differences in what the capitalized amount would represent (e.g., the incorporation of contingent rental in the present-value calculation).
Will Ratings Change (Cont.)?

• However, important rating considerations, with the potential for ratings changes, could still arise because of the following:
  – Covenant and regulatory compliance matters (reported leverage will increase);
  – New accounting or disclosures could reveal new information or risks not previously known to S&P analysts;
  – Adverse market reaction; and
  – Changes in business practices.
For Further Information…

- Standard & Poor’s Corporate Ratings Criteria—Operating Lease Analytics available on Standardandpoors.com and RatingsDirect.com.
- CreditStats Operating Lease Analytical Model available on RatingsDirect.com.
- Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project available on RatingsDirect.com.
- Standard & Poor’s Corporate Ratings Criteria available on Standardandpoors.com.
Panel Discussion