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## Proposed Lease-Accounting Requirements Likely To Affect Our Analysis

In August, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) released a long-awaited joint exposure draft, "Leases," which we believe would significantly change lease accounting, if adopted as proposed. Below, and in our recently published "*Credit FAQ: How Proposed Changes To IFRS and U.S. Lease Accounting Requirements Are Likely To Affect Standard & Poor's Credit Analysis*," we address some of the questions raised by the lease-accounting proposal relative to our credit analysis.

***Potential analytical impact and considerations:***

- If the proposals in the exposure draft are adopted, the financial statements of all companies that use leases likely will be affected, especially those lessees making the most significant use of operating leases such as retailers, and transportation and telecommunications companies.
- In our opinion, the key changes to reported amounts would include increases in liabilities, earnings measures (including EBITDA, operating income, and EBIT), and operating cash flows (i.e., because of reclassification of rent expense to financing payments).
- While both the proposed right-of-use (ROU) model and our own adjustment methodology seek to capitalize lessee obligations currently accounted for as operating, we believe the proposed model differs from our own estimate of operating lease liabilities that we add to debt in three significant respects: incorporation of renewal options and contingent rent, and discount rate used.
- We believe the first two differences could result in a materially higher amount being capitalized under the proposed ROU model than under our current methodology. Other differences between our current methodology and the proposal include differences relating to EBITDA, cash payments, and capital expenditures.
- We generally do not expect ratings to change as a result of the ROU model, if it is adopted. While reported lease assets and liabilities would likely be higher under the proposal than they are under our current adjustment methodology, we are sensitive to the fact that the calculation is different from our current approach. However, we currently consider points such as a company's economic need to use an asset for longer than the committed lease term qualitatively in interpreting our adjusted debt, earnings, and cash flow measures. Importantly, our ratings are not solely driven by the adjusted ratios; rather, we interpret these ratios under our overall credit ratings methodology.
- Nonetheless, we believe there are factors that may lead to rating changes. These include significant or sizable changes and their effect on our business and financial risk profile assessments relating to significant new information; technical compliance and market reaction; and changes in business behavior.
- We will continue to evaluate the proposal and its implications further, and monitor the ongoing deliberations of the Boards. In the meantime, we will apply our current adjustment criteria to financial statement amounts under the current accounting and reporting model.

For additional discussion on our view of the potential impact of the lease proposal, please link to our Credit FAQ article below.

**Right-Of-Use Model**
The exposure draft proposes an ROU model that would be consistent under IFRS and U.S. GAAP, and would generally require both lessees and lessors to take a similar approach to accounting for leases.

***Lessees:*** One aim of the proposed change would be for lessees to bring leases currently considered to be operating leases onto the balance sheet. Lessees would be required to recognize an asset representing the right to use a leased asset over the lease term, and a liability to make lease payments to the lessor. The ROU model eliminates the distinction between operating and capital (or finance) leases under existing accounting standards, and the concept of operating leases would be removed altogether. This generally is consistent with our view and our corporate ratings adjustment for lessee operating lease obligations.

***Lessors:*** Under the proposed ROU model, lessors would recognize an asset for the right to receive lease payments, and apply one of two methods depending on whether they retain exposure to the significant risks or benefits associated with the leased assets. These methods are:

- Performance obligation approach: In addition to the asset reflecting the right to receive payments, this approach requires a liability representing deferred revenue. The liability would be released as the right to use the asset is provided to the lessee. This would apply if the lessor retains exposure to significant risks or benefits associated with the leased asset.
- Derecognition approach: In addition to the asset representing the right to receive payments, this approach recognizes revenue for the sale of the right to use the asset and removes from the value of the underlying leased asset a portion corresponding to the lessee's right to use the asset. This approach treats the lease as a part-sale of the leased asset.

We believe the Boards will publish a final standard that would eliminate operating lease accounting. Comment letters in response to the exposure draft are due to the Boards by Dec. 15, 2010. The Boards plan to redeliberate their proposals, and expect to publish a final standard in mid-2011. Although the Boards have not yet determined when the changes would become mandatory in company reporting, we expect that, based on this timetable, the required application is unlikely before 2013.

We continue to evaluate the proposed ROU model, and intend to comment on the exposure draft. We have previously commented on the Boards' joint discussion paper on leases (see "*Standard & Poor's Ratings Services Comments On The FASB/IASB Discussion Paper Regarding Lease Accounting*," published July 21, 2009, on RatingsDirect, linked below).

(The appendix to our Credit FAQ article, below, provides further details of our understanding of the main aspects of the proposed ROU model.)

**Credit FAQ: How Proposed Changes To IFRS and U.S. Lease Accounting Requirements Are Likely To Affect Standard & Poor's Credit Analysis**

**Standard & Poor's Ratings Services Comments On The FASB/IASB Discussion Paper Regarding Lease Accounting**