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Credit FAQ:

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

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In August this year, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB), collectively "the Boards," released a long-awaited joint exposure draft, "Leases" (the ED), which Standard & Poor's Ratings Services believes would significantly change lease accounting if it is adopted.

The ED proposes a "right-of-use" (ROU) model that would be consistent under International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (U.S. GAAP), and would generally require both lessees and lessors to take a similar approach to accounting for leases. One of the main aims of the proposed change would be for lessees to bring leases that are 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 would eliminate the distinction between operating and capital (or finance) leases under existing accounting standards, and the concept of operating leases would be removed altogether. This approach is generally consistent with our own view and with our corporate ratings adjustment for lessee operating lease obligations. We describe certain differences between the specific proposal and our adjustment methodology below.

Under the proposed ROU model, lessors would recognize an asset for the right to receive lease payments, and would 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 as follows:

- Performance obligation approach: In addition to the asset reflecting the right to receive payments, this approach also requires a liability representing deferred revenue. The liability would be released as the right to use the asset is provided to the lessee. This approach 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 it likely that the Boards will publish a final standard that eliminates operating lease accounting. Comment letters in response to the ED are due to the Boards by Dec. 15, 2010. We understand that the Boards plan to redeliberate over their proposal 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 anticipate that based on this timetable, the required application is not likely before 2013.

We continue to evaluate the proposed ROU model, and intend to comment on the ED. 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).

In this Credit FAQ, we address some of the questions raised by the lease accounting proposal relative to our credit analysis.

Frequently Asked Questions

Which types of companies would be most affected as lessees?

If the proposals made in the ED are adopted, the financial statements of all companies that utilize leases are likely to be affected, especially those lessees making the most significant use of operating leases such as retailers, and transportation and telecommunications companies.

It is intended that all leases would be accounted for in the same way, so while the capitalization of leases that are currently treated as operating will result in the greatest change, amounts relating to leases currently treated as capital may also change. Companies that enter into short-term leases with renewal options (rather than committing to longer leases) would likely be affected by the proposed requirement to capitalize leases based on payments over all periods likely of renewal. Additionally, the proposed requirement to include in capitalized payments not only the minimum lease payments but also an estimate of contingent rent, would likely increase the liabilities and assets of companies whose lease payments are linked to contingencies such as revenue generated through their use of leased retail space.

How would amounts reported by lessees change under the proposal?

We previously summarized the current approaches to lease accounting under IFRS and U.S. GAAP (see "Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project," published Aug. 2, 2006, on Ratings Direct). While, in our view, significant differences exist between the two accounting systems at a detailed level, both IFRS and U.S. GAAP broadly result in operating and capital leases. Operating leases are off the balance sheet, with rent being recognized on a straight-line basis over the lease term, and capital leases result in assets and liabilities based on the present value of minimum lease payments over the lease term, with depreciation and interest expense being recorded.

Under the proposed ROU model, the initial measurement of both the lease assets and liabilities would include the present value of lease payments over the lease term. The lease term would be the committed lease term, plus any additional periods under renewal options that are more likely than not to be taken up. Expected payments (including estimates of contingent rents, residual guarantees, and term option penalties) would be discounted at the lessee's incremental borrowing rate at the inception of the lease. Lease assets would also include the capitalization of direct costs incurred. We provide additional details on the proposed ROU model in the Appendix.

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. We believe that the specific impact on reported amounts may include:

On the balance sheet:

- Reported assets: These would include the amortized cost value of ROU assets. The amounts would be presented separately within the respective category of the leased asset (for example, within the relevant category of property plant and equipment).
- Reported liabilities: These would include the amortized cost value of the lease liabilities, presented separately from other financial liabilities. Leverage measures that include lease liabilities as debt would deteriorate.

- Reported shareholders' equity: The initial lease asset and liability would generally be amortized under different methodologies. As a result, the lease asset and liability would typically be carried at different amounts, thereby affecting reported equity.
- Leases currently considered to be operating: Newly recorded lease assets and liabilities would increase reported assets and liabilities.
- Leases currently considered to be capital: Changes in the measurement of amounts would likely increase reported lease assets and liabilities, particularly for leases with renewal options, contingent rentals, and residual value guarantees that are not currently included in the capitalized amounts.
- Reassessment: Asset and liability amounts would be reassessed for significant changes in both the lease term and expected payments.

In the profit or loss statement:

- Operating lease rental expense would be replaced by amortization of the ROU asset and interest expense on lease liabilities, thereby likely increasing currently reported EBITDA, operating income, and EBIT.
- Interest expense would typically be higher in earlier periods under the effective interest method, as this method applies a constant rate of interest to the outstanding liability over time.
- The reassessment of expected payments associated with current or past periods--for example, payments related to sales of the current year--may result in an adjustment to profit or loss.

In the statement of cash flows:

- Cash lease payments would be shown as financing activities, increasing cash flows from operations as currently reported.

Will subleases or lessor receivables reduce a lessee's reported lease liabilities?

Lessor receivables will not reduce a lessee's reported lease/head lease liabilities, whether they arise from separate lessor transactions or from sublease arrangements. A lessee that subleases the right of use of underlying assets would effectively be treated as both a lessee (with respect to the head lease) and lessor (with respect to the sublease). The head lease and sublease would be accounted for separately. Additional information on proposed lessor accounting is presented in the Appendix.

We understand that under the performance obligation approach to lessor accounting, three related amounts under the sublease would be presented together in the balance sheet as a net asset or liability, showing separately the component ROU assets, rights to receive lease payments under subleases, and lease liabilities (effectively deferred sublease revenue). The liability to pay under the head lease would be shown separately in liabilities. The netting of sublease-related amounts avoids showing two assets (ROU and receivable) and two liabilities (deferred revenue and lease payment liability) for the head lease and sublease of the same underlying assets.

For the separate lessee and lessor activities of a company that has both types of arrangements (unrelated to subleases), and for subleases accounted for under the derecognition approach to lessor accounting, receivable and head lease liability amounts would generally be shown separately and 'gross' on the balance sheet. However, detailed disclosure identifying components of profit or loss amounts related to leasing activities (for example, interest income and expense) may be shown in the footnotes to the financial statements rather than separately on the profit or loss statement.

Does the proposed approach differ significantly from the operating lease adjustments that Standard & Poor's currently makes in its corporate rating analysis?

In some cases, the on-balance-sheet and income statement amounts that companies would report may differ significantly from our current adjustment, which also capitalizes lease obligations that are reported as operating. Under our adjustment methodology, we generally capitalize operating leases based on the minimum lease payments disclosed by companies, discounted at a rate that estimates the rate implicit in the company's lease arrangements. The intention of this is to approximate the value of lease obligations incurred, regardless of whether the company has capitalized them on the balance sheet or not. (For further details, see "Encyclopedia Of Analytical Adjustments" within "Corporate Ratings Criteria 2008," published April 15, 2008, on RatingsDirect.)

While both the proposed ROU model and our own adjustment methodology seek to capitalize lessee obligations currently accounted for as operating, we consider that the proposed model differs from our own estimate of operating lease liabilities that we add to debt in three significant respects (and additional differences may occur in specific circumstances). These differences would also follow through to the related recognition of cost as amortization and interest in the profit or loss statement. The three differences are as follows:

- Renewal options: Payments for periods subject to renewal options that are more likely than not to be taken up would be included in capitalized lease payments. These additional periods are not generally included in the current disclosure of minimum lease payments, which is the basis for our adjustment.
- Contingent rent: Contingent rent payments would be included in the capitalized amount. These are also not generally included in disclosed minimum lease payments used in our calculation.
- Discount rate: We use a single broad estimate of rates implicit in the company's overall lease arrangements. On transitioning to the new requirements under the ED, companies would use their incremental borrowing rate at the time of the transition. For new leases entered into subsequently, companies would use rates specific to the time they entered into the leases.

We believe that 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:

- EBITDA: Our current methodology does not add back to EBITDA the full amount of rent expense that under a capitalization model is replaced by depreciation (amortization) and interest expense. We only add back an imputed interest element, not depreciation. Under the proposed model, EBITDA derived from reported amounts would be increased by the full amount of what is rent expense under current accounting.
- Cash payments: All lease payments would be reflected as financing, rather than operating cash outflows. Under our adjustment methodology, we typically add back to reported cash flows from operations (CFO) and to our funds from operations (FFO) measures a portion of rent that we consider to approximate the depreciation of the capitalized lease assets. As a result, our adjusted CFO and FFO measures only include the portion of rent paid that we consider represents an interest component.
- Capital expenditures (capex): Our current methodology adds to capex an implied addition to leased assets. While the amount related to capitalized leases is disclosed under IFRS and U.S. GAAP, for operating leases we calculate the amount based on the change in our estimated operating lease debt, plus estimated depreciation for the year. In our view, company-calculated additions to leased assets, based on all leases being capitalized under the proposal, will likely differ from our methodology and would be disclosed as a noncash transaction.

Will Standard & Poor's modify its corporate ratings operating lease adjustment criteria?

We expect that we would need to change aspects of our adjustment methodology if the proposal is adopted, because companies would already capitalize all leases in their reported amounts under revised IFRS and U.S. GAAP. We will continue to evaluate the proposal and its implications further, and monitor the ongoing deliberations of the Boards. In the meantime, we continue to apply our current adjustment criteria to financial statement amounts under the current accounting and reporting model.

Will the ratings on companies with significant lessee obligations be affected?

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.

However, we believe there are points that are more likely to 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: Companies could identify and capitalize leases that had not previously been disclosed. New and enhanced disclosures on leases and their terms may also require greater transparency of leasing decisions and management's judgments in reporting lease activity. In our view, this aspect may be significant for some issuers, as many currently provide limited transparency of their lease obligations. It is also not infrequent that we see changes in disclosure from year to year, for example, resulting from a closer examination of leases by a new auditor or as a result of a company's internal exercises focused on the reporting of lease data by subsidiaries for aggregation and group disclosure. An exercise such as the proposed transition to new requirements for all leases, particularly as it brings operating leases out of being 'disclosure only' into full accounting on the balance sheet, is likely to result in newly identified leases by some companies. We would need to consider any new information resulting from the revised requirements in our ratings analysis.
- Technical compliance, market reaction: Problems with debt covenant compliance or compliance with other technical requirements could potentially have an impact on borrowing capacity or give rise to other liquidity issues. A company's capital providers may also respond to new information provided by the company. In our view, compliance with debt covenants based on reported financial statement amounts may be adversely affected by the proposed changes, particularly requirements linked to debt levels that include lease obligations. However, the impact on debt may be mitigated by the increase in various reported earnings measures and operating cash flows. While some companies may need to renegotiate how financial ratios specified in covenants are calculated, or obtain waivers, based on our experience of other significant accounting changes, we anticipate that generally, most companies should address this in an orderly fashion.
- Changes in business behavior: Companies may change their lease-versus-buy strategies or begin to negotiate different lease terms (perhaps entering into leases without renewal options). We think it possible that such changes could signal a shift in a company's business or financial risk profile.

APPENDIX: How Does The Proposed ROU Model Work?

We summarize our understanding of the main aspects of the proposal below.

Scope of the proposal

- The model would apply to all leases (including subleases), except leases of intangible assets, leases to explore for or use natural resources, leases of biological assets, and leases of investment property accounted for at fair value under IFRS.
- The service components of lease contracts (for example, services to maintain the asset) are addressed separately under revenue recognition requirements rather than as part of the ROU lease accounting, as long as they can be distinguished.
- Purchase options are excluded from ROU lease payments and would only be accounted for when exercised, but a bargain purchase option (an option priced significantly lower than the expected fair value of the asset when the option becomes exercisable) could result in the arrangement being treated as a sale rather than a lease.

Lessee's ROU asset

- Initial measurement: ROU assets would initially be measured at the amount of the lessee's liability to make lease payments (see below), plus any initial direct costs incurred by the lessee.
- Amortized cost accounting: The asset would generally be carried at amortized cost, with amortization charged to the income statement over the lease term. Amortization would be taken on a systematic basis over the lease term (typically on a straight-line basis, or using a method that better reflects the consumption of the benefits associated with using the asset). The asset would also be assessed for impairment.

Lessee's liability to make lease payments

- Initial measurement: The lessee's liability to make payments would initially be measured at the present value of the lease payments over the lease term.
- Lease term: This is the longest lease term that is more likely than not to occur, taking into account options to extend or terminate the lease. Companies would estimate the probability for each possible lease term, considering all explicit and implicit options to extend or terminate the lease.
- Lease payments: Payments would be estimated on the basis of an expected outcome technique, including probability-weighted estimates of payments that include contingent rentals, residual guarantees, and term option penalties.
- Discount rate: The lessee's incremental borrowing rate at lease inception would be used. The rate that the lessor charges the lessee (the implicit rate) could be used if it is readily determinable. For leases with a term of 12 months or less, a lessee may elect not to discount the lease payments.
- Amortized cost accounting: The liability would be carried at amortized cost, increasing over time for interest accrued at the discount rate, and decreasing for cash lease payments made. As a result, interest expense would be greater in the earlier years of the lease.

Reassessment by lessees

- At each balance sheet date, the lessee's liability to pay would be reassessed if facts and circumstances were to indicate a significant change in the lease term or the expected payments. The discount rate used at lease inception would not generally be changed.
- The change in the lessee's liability would be recognized in profit or loss to the extent that it related to expected

payments for contingent rent, term option penalties, or residual value guarantees associated with the current or past periods. Otherwise, it would be recognized as a change in the value of the ROU asset (for example, changes in estimated future rent based on future sales).

Lessor's right to receive payments

- Initial measurement: An asset for the right to receive lease payments would be determined on the same basis as the lessee's liability, except that payments for contingent rentals and expected payments under residual value guarantees and term option penalties would only be included if they could be measured reliably, and the lease payments receivable would be discounted based on the rate charged to the lessee.
- Amortized cost accounting: The asset would be carried at amortized cost, increasing over time for interest accrued at the discount rate, and decreasing for cash lease payments received. As a result, interest income would be greater in the earlier lease years. The asset would also be assessed for impairment.

Lessor's performance obligation approach

- General requirements: If the lessor were to retain exposure to significant risks or benefits associated with the leased asset, it would recognize a lease liability (essentially deferred revenue in an amount corresponding to the right to receive payments). The lease liability would be amortized as revenue over the lease term based on the pattern of use of the asset by the lessee (or alternatively, on a straight-line basis). There would be no change to the accounting for the underlying leased asset, which would remain on the balance sheet. Lessors would present the underlying leased asset, the right to receive payments, and the lease liability, together with the net amount of these three components, on the balance sheet as a net asset or liability.
- Profit or loss statement: The statement would include interest income accrued on the receivable, lease income from satisfying the lease liability (essentially by allowing the use of the asset), and depreciation of the underlying leased asset.

Lessor's derecognition approach

- General requirements: If the lessor does not retain exposure to significant risks or benefits associated with the leased asset, lease income would be recognized immediately for the sale of the right to use the asset delivered to the lessee. A corresponding portion of the asset would also be removed as the cost related to the sale, and the residual amount of the underlying asset would be transferred out of owned assets.
- Profit or loss statement: The statement would include interest income accrued on the receivable, lease income based on the present value of lease payments, and cost for the portion of the leased asset removed from the balance sheet. The residual asset would not be depreciated, but would be assessed for impairment.

Lessor's statement of cash flows

- Cash received would be included in operating cash flows.

Reassessment by lessors

- At each balance sheet date, the lessor's asset for the right to receive payments would be reassessed if facts and circumstances indicated a significant change in either the lease term or expected payments that can be measured reliably. The discount rate used at lease inception would not generally be changed.
- The change in the lessor's value of the right to receive payments would be recognized under the performance obligation or derecognition approach.
- Performance obligation approach: Changes resulting from changes to the lease term would be taken as an adjustment to the lease liability, while changes to expected lease payments would adjust the liability for the future

use of the asset, and adjust profit or loss for the past use of the asset (or if reducing the liability would bring it below zero).
- Derecognition approach: Changes resulting from changes to the lease term would be taken as an adjustment to the rights derecognized and the residual asset. Additionally, changes to expected lease payments would be taken directly to profit or loss.

Presentation
- Lease-related amounts would generally be made apparent either through separate presentation on the face of the financial statements, or disclosed in the footnotes.

Disclosure
- The proposal would require more detailed disclosures of leasing activities, including the disclosure of quantitative and qualitative information that identifies and explains leasing-related amounts recognized in the financial statements, and describes how leases may affect the amount, timing, and uncertainty of future cash flows.
- Disclosure would be provided of contingent rent terms, and of the existence and terms of renewal and termination options (and those recognized and not recognized as part of a lessee's ROU asset and lease liability).
- Disclosures would also include information about significant assumptions and judgments and any changes in assumptions and judgments relating to renewal options, contingent rentals, term option penalties, residual value guarantees, and the discount rate used.
- A reconciliation of the opening and closing balances of lease assets and liabilities would also be required.

Transition
- No grandfathering is proposed and the accounting would change for all leases in existence when the accounting change is implemented. The ROU model would be applied retrospectively, resulting in assets and liabilities being recorded under the model for all outstanding leases at the beginning of the first comparative period presented.
- For example, if the changes were first applied for the calendar year 2013, 2012 amounts would be restated under IFRS (2011 and 2012 under U.S. GAAP for public companies). Amounts at the beginning of 2012 (2011 under U.S. GAAP) would be restated based on the present value of the remaining payments under lease arrangements on Jan. 1, 2012 (Jan. 1, 2011, under U.S. GAAP), discounted at the incremental borrowing rate on that date (companies will not have to determine the rate applicable at the initiation of each lease they entered into previously).

Related Criteria And Research

- Standard & Poor's Ratings Services Comments On The FASB/IASB Discussion Paper Regarding Lease Accounting, July 21, 2009
- Encyclopedia Of Analytical Adjustments, within Corporate Ratings Criteria 2008, April 15, 2008
- Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project, Aug. 2, 2006

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