



R&I's Analytical Approach to Lease Transactions

(This report is an English translation of the original report in Japanese.)

R&I's considerations when evaluating operating lease transactions

Under Japanese accounting standards, lease transactions are accounted for as either finance lease transactions or operating lease transactions. For finance leases, accounting treatment based on the methodology for ordinary sale and purchase transactions is applied ("on-balance sheet treatment"), while accounting treatment based on the methodology for ordinary leases ("off-balance sheet treatment") has been adopted for operating lease transactions. Under U.S. accounting standards as well, leases are classified as capital leases and operating leases, and in terms of content there are no major differences from Japan's standards.

While the accounting treatment for finance lease transactions and operating lease transactions differs, even among operating lease transactions there are instances where use of a leased asset generates cash flow and the asset in question is essential for the lessee's business. When a company leases an item from a leasing company as an operating lease, frequently this is substantively no different than the company borrowing interest-bearing debt and investing the funds in capital equipment. Consequently the handling of evaluations of operating lease transaction creditworthiness becomes a point at issue. Real estate is subject to the application of lease accounting even if there is a "rental agreement," regardless of whether the agreement is a lease agreement. For a real estate lease transaction assumed to be an operating lease transaction, the handling of the transaction for the evaluation of creditworthiness is a point of contention, just as with other lease assets.

Prior to the revision of Japan's lease accounting standard in fiscal 2008, finance lease transactions that did not transfer ownership rights of the property to the lessee at maturity were exceptionally subject to off-balance sheet accounting treatment, on the condition they are disclosed in certain notes. Under the revised standards, this exception handling was abolished and such leases are currently subject to on-balance sheet treatment. Companies, however, can continue to treat lease transactions for which the date when the lease transaction began was before the first fiscal year in which the company applied the new accounting standards as off-balance sheet transactions. Care is required during financial analysis because differences in the amount recorded on the balance sheet for lease obligations will arise as a result of the accounting treatment selection.

Reform of international accounting standards is proceeding in the direction of accounting for all lease agreements based upon recognition of the acquisition of the right to use the lease asset,

and the corresponding leasing fee payment obligation burden, as an alternative to the classification into finance lease transactions and operating lease transactions. As the probability that transactions accounted for as on-balance sheet items continues to increase, the need for financial adjustments that match economic realities is greater than ever.

Methodology for adjusting financial statements when evaluating ratings

When the use of an asset such as machinery or equipment accounted for as an operating lease transaction generates cash flow, and the asset in question is essential for the lessee's business, R&I will adjust the financial statements by viewing financially material assets as assets that were procured or purchased with borrowed funds, and perform its rating evaluation by considering the influence on the lessee's creditworthiness.

For financial analysis purposes, R&I considers the present value of the total lease payments that are to be paid in the future as a lease obligation to be equivalent to interest-bearing debt. In this visualization, the lease obligation is the amount calculated by subtracting the amount corresponding to interest from the future lease payments on the operating lease transaction that the object of the adjustment. The lease payments paid are transferred to depreciation and amortization expense and interest paid on the income statement and statement of cash flows. If necessary, the value equivalent to depreciation and amortization expense is transferred to cost of goods sold and to selling, general and administrative expenses.

Real estate (buildings) that is subject to conditions such as a short-term contract period or payments that do not correspond to a full payout in many cases is accounted for as an operating lease transaction. When the form of the contract and the asset in question are essential to the lessee's business R&I will adjust the financial statements to match the economic reality by considering the lessee to have borrowed funds and purchased the asset.

In the retail industry, for example, R&I will make an adjustment to account for stores as an on-balance sheet asset. R&I will multiply the rents included in selling, general and administrative expenses by the estimated remaining contract term for stores as determined according to the conditions in each industry, such as department stores, GMS or supermarkets, and add expenses other than amortization expense, and the amount excluding interest, to interest-bearing debt. R&I also adds an amount calculated by multiplying the lease payments by certain coefficients to the cash flow in each period, as depreciation and amortization expense.

Lease transactions for which the date when the lease transaction began was before the first fiscal year in which the lessee applied the new accounting standard continue to be accounted for as off-balance sheet transactions. For assets that are financially material to the extent they will affect the rating evaluation as well, R&I will adjust the financial statements, just as it does for operating lease transactions.

For sale and leaseback transactions accounted for as operating lease transactions, any gain or loss on sale based on off-balance sheet accounting treatment is recorded in a lump-sum, just as

with a normal sales transaction. When R&I has made an adjustment to the subject asset to account for it as an on-balance sheet item, R&I will adjust the financial statements in some cases, if the amount of the gain or loss on sale is material, by deferring the gain or loss on sale as a long-term prepaid expense (deferred revenue) and amortizing the amount in proportion to the lease asset depreciation and amortization expense, just as it does for finance lease transactions.

Items R&I will note when making financial statement adjustments

R&I must perform its financial analysis after considering the nature of operating lease transactions and the limits of accounting treatment. To treat assets that fulfill the conditions of lease rental agreements to a limited extent as finance lease transactions, the determination of whether an operating lease transaction exhibits the financial character of a finance lease transaction differs greatly with each individual case. In contrast to the lease term for a finance lease transaction, which is restricted to the statutory useful life of the property and is full-payout, the lease term of operating lease transactions can be set freely and the parties to the agreement can also structure the terms, such as gradually increasing the payment amount and establishing a large residual value.

When a company rents its corporate headquarters building under a fixed-term lease agreement, in order to control property rent, there is a possibility the future lease payments cannot be measured and will be omitted from the notes to the financial statements if, in contrast to a note highlighting large lease payments as future lease payments (i.e., the future portion of a "simple lease agreement with a fixed term non-cancellation clause" is noted as an operating lease transaction), the non-cancellation period under a general lease agreement is unclear. With general leases as well, in many cases the corresponding maturity frequently is extended and, as a reality, there is little difference between fixed-term lease and general lease transactions. R&I considers adjustments to financial statements based only on information released externally to be difficult.

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