February 2006

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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[1] 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.

1. *See Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations — Part I, July 2005 (#93570).*
2. *See Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations — Part II, February 2006 (#96729).*
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[4] 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.

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 comparisons that are critical to our ratings. Moody's has published methodologies relating to several of the Standard Adjustments 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 financial 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 permitted 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, attributing 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 1998 (#39330) Analytical Observations Related to US Pension Obligations, January 2003 (#77242) **See Standard Adjustment # 1 — Defined Benefit Pensions for changes to the previously published methodology**
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 an 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 (#76852)
Hybrid securities	To classify securities with characteristics of both debt and equity following Moody's classification scheme, which sometimes differs from the GAAP treatment. We adjust interest expense, dividends and related cash flows consistent with our classification of the hybrid security.	Moody's Tool Kit: A Framework for Assessing Hybrid Securities, December 1999 (#49802) Hybrid Securities Analysis — New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities, November 2003 (#79991) Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!, March 2005 (#91696) **See: Standard Adjustment #6 — Hybrid Securities for changes to the November 2003 methodology**
Securitizations	To adjust the sponsor's accounting for securitizations that do not fully transfer risk and that are accounted for as sales of assets. Moody's views those transactions as collateralized borrowings.	Securitization and its Effect on the Credit Strength of Companies: Moody's Perspective 1987-2002, March 2002 (#74455) Changing the Paradigms: Revised Financial Reporting for Special Purpose Entities, May 2002 (#74947) Demystifying Securitization for Unsecured Investors, January 2003 (#77213)
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)[5] 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[6]. 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.

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 employees. 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.*

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.

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[7] 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.

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 2a: Standard Adjustments for Unfunded Defined Benefit Pensions

Balance Sheet	We adjust the balance sheet to record an "equity credit" that simulates funding of the company's unfunded PBO. Our adjustment: • reverses a portion of the debt recognized in Part 1 of our adjustment for defined benefit pension plans, and • recognizes a corresponding increase in equity.
Income Statement	We do not further adjust the income statement for unfunded pension plans, other than to align the interest expense with our adjustment to debt.
Cash Flow Statement	We do not further adjust the cash flow statement for unfunded pension plans.

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 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

The following table describes Moody's adjustments to capitalize operating leases. Worksheet B in the Appendix provides the detail underlying the calculations.

Table 3: Standard Adjustments for Operating Leases	
Balance Sheet	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 will use the PV.
Income Statement	We adjust the income statement using market convention to reclassify one-third of the rent expense to interest expense and the remaining two-thirds rent to "Depreciation - Capitalized Operating Leases" (a component of operating profit), and we adjust operating expenses (or cost of goods sold and selling, general & administrative expenses) proportionally.
Cash Flow Statement	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.

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 4: Standard Adjustments for Capitalized Interest	
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.*

Standard Adjustment #4: Employee Stock Compensation

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 5: Standard Adjustments for Employee Stock Compensation

Balance Sheet	We adjust the balance sheet as if the stock options had been recorded as an expense. Our adjustments: • reduce retained earnings by the amount of after-tax pro-forma stock compensation expense; and • increase common stock as if stock had been issued; and • reduce deferred tax liabilities due to the decrease in tax expense.
Income Statement	We adjust the income statement as if the company expensed stock options. Our adjustment: • increase SG&A expense by the amount of "pre-tax" pro-forma stock compensation expense; and • reduce tax expense by the amount of the incremental tax rate times the pre-tax pro-forma stock compensation expense.
Cash Flow Statement	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).

Standard Adjustment #5: Hybrid Securities

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:

Basket	Debt Component	Equity Component
A	100%	0%
B	75%	25%
C	50%	50%
D	25%	75%
E	0%	100%

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[8], 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

Balance Sheet	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
Income Statement	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
Cash Flow	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.

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 deferrable, 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.*

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.

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 8: Standard Adjustments for Securitizations	
Balance Sheet	We adjust the balance sheet to increase debt by the ending balance of uncollected or unrealized assets that the company sponsor transferred in the securitization arrangement as of the balance sheet date. We also increase assets of the appropriate category by the same amount.
Income Statement	We impute interest expense on the amount of additional debt recognized, at the borrowing rate implicit in the company's securitization arrangement or the company's short-term borrowing rate, and reduce other expense by the same amount. Thus, our adjustment does not affect reported net income

Cash Flow	We adjust the cash flow statement to reclassify amounts in the cash from operations (CFO) and cash from financing (CFF) categories:
	• upon the initial transfer of assets, we reclassify the cash inflow from operating cash flow (CFO) to financing cash flow (CFF).
	• for each subsequent period, we base the amount of reclassification on changes in uncollected or unrealized sponsor assets in the securitization arrangement from the beginning to the end of the period. For example if the amount of uncollected receivables in the securitization:
	  • increases from the beginning to the end of the year, we reclassify the amount of that increase from cash inflow from operations (CFO) to cash inflow from financing activities (CFF).
	  • decreases from the beginning to the end of the year, we increase cash from operations (CFO) by that amount and decrease cash from financing activities (CFF).

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 9: Standard Adjustments for Inventory on a LIFO Cost Basis	
Balance Sheet	We adjust the balance sheet to: • increase inventories by the amount of the LIFO inventory valuation reserve • increase deferred tax liabilities for applicable tax effects • increase retained earnings.
Income Statement	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.
Cash Flow	We do not adjust the cash flow statement

Standard Adjustments #8 and #9: Unusual and Non-Recurring Items - Income and Cash Flow Statements

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 10: Standard Adjustments for Unusual and Non-Recurring Items - Income and Cash Flow Statements

Balance Sheet	We adjust the balance sheets in those instances when it is material to our analysis.
Income Statement	We adjust the income statement to reclassify the effects of unusual or non-recurring revenues, gains or costs, net of the related tax effect, to a special income statement caption that is below net profit after tax. Our computation of key ratios excludes amounts in the special income statement caption.
Cash Flow Statement	We adjust the cash flow statement to reclassify the effects of unusual or non-recurring operating cash inflows and outflows to a special caption in the operating section of the cash flow statement. Our computation of key ratios excludes amounts in the special cash flow statement caption.

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.

Worksheet	Adjustment
A	Underfunded/Unfunded defined benefit pensions
B	Operating leases
C	Capitalized Interest
D	Employee stock compensation
E	Hybrid securities
F	Securitizations
G	Inventory on a LIFO cost basis
H	Unusual and non-recurring items - income statement
I	Unusual and non-recurring items - cash flow statement
J	Non-standard adjustment - public information

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)

← from the "Pension" note included in the financial statement footnotes

Projected Benefit Obligation (End of Year)		**(a)**		
Fair Value of Plan Assets (End of Year)		**(b)**		
Net Periodic Pension Benefit Cost (Income)		**(c)**		
Service Cost		**(d)**		
Interest Cost		**(e)**		
Actual Return on Plan Assets		**(f)**	Indicate accounts where amounts are recorded	
Employer Contributions		**(g)**	Account #	Account Description
Pension Asset Recorded		**(h)**		
Pension Liability Recorded		**(i)**		

Step 2 - Additional Pension Disclosure Information for Unfunded Pension Plans

from the "Pension" note included in the financial statement footnotes

Unfunded Projected Pension Benefit Obligation (End of Year)		**(j)**
Service Cost for Unfunded Pensions (excl OPEB - if disclosed)		**(k)**

Step 3 - Other Disclosure Information Used in Calculations:

a. Common Input for Both Underfunded and Unfunded Plans

Cost of Goods/Products/Services Sold	-	**(l) ***	
Operating Expenses	-	**(m) ***	
Selling, general and administrative expenses	-	**(n) ***	
Incremental LT Borrowing Interest Rate	-	**(o) ***	FROM "MANDATORY SUPPLEMENTAL INFO"
Incremental Tax Rate	-	**(p) ***	FROM "MANDATORY SUPPLEMENTAL INFO"

b. Additional Input for Unfunded Plans

Analyst Estimate: "Ideal" Percentage of Debt to Debt + Equity	-	**(q)**	
Analyst Estimate: "Excess" cash related to *unfunded* pensions	-	**(r)**	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)*

	Debit	(Credit)		
Accumulated Other Comprehensive Income	$ -	$ -		= (h) - (i) - (s) - (t)
Deferred Tax Liabilities	-	-	(s)	= [(h) - (i) - (t)] x (p)
Pension Liabilities Recorded	-	-		= (i)
Pension Assets Recorded	-	-		= (h) x -1
Bonds/Senior Debt	-	-	(t)	= If (a) - (j) > (b) then (b) - (a) else (j) x -1

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

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

Senior Debt	$ -	$ -	(u)	= [(j) - (r)] x [1 - (q)]
Total Retained Earnings	-	-		= (u) x -1

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

(A)-3 *(Income Statement)*

Cost of Goods/Products/Services Sold	$ -	$ -		= [(d) - (c)] x [(l) / [(l) + (m) + (n)]]
Operating Expenses	-	-		= [(d) - (c)] x [(m) / [(l) + (m) + (n)]]
Selling, general and administrative expenses	-	-		= [(d) - (c)] x [(n) / [(l) + (m) + (n)]]
Other Non-Recurring Expenses/(Gains)	-	-	(v)	= If (e) - (w) > (f) then (e) - (w) - (f)
Interest Expense	-	-	(w)	= [(u) + (t)] x (o) x -1
Taxes	-	-	(x)	= [(d) - (c) + (v) + (v)] x (p) x -1
Unusual & Non-Recurring Items - Adjust. After-tax	-	-		= [(d) - (c) + (v) + (w) + (x)] x -1

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

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

	Source	(Use)	
Changes in Other Oper. Assets & Liabilities - LT	$ -	$ -	If (g) > (d) - (k) then (g) - [(d) - (k)]
Other Financing Activities	-	-	

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.

Company Name:

Financial Statement Period Ended:

Amounts in US$'000

Step 1 - Use Multiple to Calculate Capitalized Lease Obligation

Current Year Rent Expense		**(a)**	
Multiple of Rent to be used to calculate debt:	-	**(b)**	
Multiple x Rent Expense		**(c)**	**= (a) x (b)**

Step 2 - Use Minimum Lease Commitments to Calculate Present Value

Incremental LT Borrowing Interest Rate		**(d)**	
	Disclosure of Minimum Lease Commitments		
Year 1 (next fiscal year)	-	**(e)**	
Year 2	-		
Year 3	-		
Year 4	-		
Year 5	-		
Thereafter	-		
Sum of Minimum Lease Commitments			
PV of Lease Commitments	**-**		**(f)**

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

Incremental Debt and Addition to PP&E	**(g)**	**-**	Greater of Multiple x Rent Expense **(c)** and PV of Minimum Lease Commitments **(f)**
Depreciation Component of Rent Expense	**(h)**	**-**	Current Year Rent Expense **(a)** x ⅔
Interest Component of Rent Expense	**(i)**	**-**	Current Year Rent Expense **(a)** x ⅓

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

	Debit	(Credit)	
(B)-1 *(Balance Sheet)*			
Gross Plant	$ -	$ -	(g)
Capitalized Leases (Gross)		-	(g) x -1
Current portion of long-term debt		-	(e) x ⅔ x -1
Less: Current Maturities	-		(e) x ⅔

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

	Debit	(Credit)	
(B)-2 *(Income Statement)*			
Interest Expense	$ -	$	(i)
Cost of Goods/Products/Services Sold		-	(i) x [(j) / [(j) + (k) + (l)]] x -1
Operating Expenses		-	(i) x [(k) / [(j) + (k) + (l)]] x -1
Selling, general and administrative expenses		-	(i) x [(l) / [(j) + (k) + (l)]] x -1
Depreciation - Capitalized Operating Leases	-		(h)
Cost of Goods/Products/Services Sold		-	(h) x [(j) / [(j) + (k) + (l)] x -1
Operating Expenses		-	(h) x [(k) / [(j) + (k) + (l)] x -1
Selling, general and administrative expenses		-	(h) x [(l) / [(j) + (k) + (l)] x -1

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

	Source	(Use)	
(B)-3 *(Cash Flow Statement)*			
Depreciation & Amortization	$ -	$	(h)
Long-term Debt Payments		-	(h) x - 1
Long-term Debt Proceeds	-		(h)
Additions to P.P. & E. (Capital Expenditures)		-	(h) x - 1

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

Supporting Calculations:

	Disclosed Commitment	
Year	Minimum Lease Payments	Cumulative Minimum Lease Payments
1	-	-
2	-	-
3	-	-
4	-	-
5	-	-
6	-	-
7	-	-

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"):

(C)-1 *(Balance Sheet)*

	Debit	(Credit)	
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)*

	Debit	(Credit)	
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)*

	Source	(Use)	
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:

(D)-1 (Balance Sheet / Income Statement) - If (c) is "Yes"	**Debit**	**(Credit)**	
Operating Expenses	**$ -**		**(f) = [(a) - (b)] / [1 - (e)]**
Long Term Deferred Tax Account	**-**		**(g) = (f) x (e)**
Retained Earnings	**-**		**(h) = [(f) - (g)]**
Common Stock & Paid-in-Capital		**$ -**	**= (f) x -1**
Taxes		**-**	**= (g) x -1**
Unusual & Non-Recurring Items - Adjustments After Tax		**$ -**	**= (h) x -1**

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

(D)-2 (Cash Flow Statement)	**Inflow**	**(Outflow)**	
Stock Option/Warrant Proceeds (Financing Cash Flows)	**$ -**		**(d)**
Other Operating Cash Flows (Operating Cash Flows)		**$ -**	

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 expenseor 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

Moody's Hybrid Securities Baskets:

Basket	Moody's % Equity	Moody's % Debt
A	0%	100%
B	25%	75%
C	50%	50%
D	75%	25%
E	100%	0%

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

	Amount Outstanding	Est. Interest Expense	Moody's Basket	Reclass to Equity	Reclass to Preferred Dividends	Description of Hybrid Security
Hybrid Security #1	-	-		-	-	
Hybrid Security #2	-	-		-	-	
Hybrid Security #3	-	-		-	-	
Hybrid Security #4	-	-		-	-	
		Total Reclassifications		**$ - (a)**	**$ - (b)**	

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

	Amount Outstanding	Dividends	Moody's Basket	Reclass to Debt	Reclass to Interest Expense	Description of Hybrid Security
Hybrid Security #1	-	-		-	-	
Hybrid Security #2	-	-		-	-	
Hybrid Security #3	-	-		-	-	
Hybrid Security #4	-	-		-	-	
		Total Reclassifications		**$ - (c)**	**$ - (d)**	

Step 3 - Gather information on Hybrid Securities Classified as Minority Interest (in the "As Reported" numbers):

	Amount Outstanding	Amount Charged to Expense	Moody's Basket	Reclass to Debt	Reclass to Interest Expense	Description of Hybrid Security
	(e)	(f)				
Hybrid Security #1	-	-		-	-	
Hybrid Security #2	-	-		-	-	
Hybrid Security #3	-	-		-	-	
Hybrid Security #4	-	-		-	-	
Total Reclassifications				**$ - (g)**	**$ - (h)**	

Step 4 - Adjustments:

	Debit	(Credit)	
(E)-1 (Balance Sheet)			
	$ -		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)
	-		
	-		
	-		
Preferred Stock		$ - (a)	

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

(E)-2 (Balance Sheet)

	Debit	(Credit)
Preferred stock	$ -	(c)
Subordinated debt		$ -

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

(E)-3 (Income Statement)

	Debit	(Credit)
Preferred Dividends Declared	$ -	(b)
Interest Expense		$ -

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)-4 (Income Statement)

	Debit	(Credit)
Interest Expense	$ -	(d)
Preferred Dividends Declared		$ -

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)

	Inflow	(Outflow)	
Net Income (Operating Cash Flow)	**$ -**		**(b)**
Cash Dividends Preferred		**$ -**	

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)

Cash Dividends Preferred	**$ -**		**(d)**
Net Income (Operating Cash Flow)		**$ -**	

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)

	Debit	(Credit)	
Minority Interest	-		**= ∑ (e)**
Subordinated debt		-	**= (g) x -1**
Preferred stock		-	**= [∑ (e) - (g)] x -1**

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)

	Debit	(Credit)	
Interest Expense	$ -		**= (h)**
Preferred Dividends Declared	-		**= ∑ (f) - (h)**
		-	
		-	**= (f) x -1**
		-	
		-	

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)

	Inflow	(Outflow)	
	$ -		
	-		**= (f)**
	-		
	-		
Net Income		-	**= (h) x -1**
Cash Dividends - Preferred		-	**= (h) - ∑ (f)**

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:

(F)-1 (Balance Sheet)

		Debit	(Credit)	
	Asset account to be adjusted	**$ -**		**(b)** ← Analyst will have to enter the name of the asset account affected
	Liability account to be adjusted		**$ -**	

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*

(F)-2 (Income Statement)

		Debit	(Credit)	
	Interest Expense	**$ -**		**(c) x (d)**
	Income statement account to be used for adjustment against interest expense		**$ -**	**(c) x (d) x -1**

Purpose: *To impute interest expense on the amount of unrecognized debt at the company's short-term borrowing rate*

(F)-3 (Cash Flow Statement)

	Inflow	(Outflow)	
Changes in Working Capital Items	**$ -**	**$ -**	**(a) - (b)**
Net Short-term Debt Changes	**-**	**-**	**(b) - (a)**

Purpose: *To recognize the cash effects of changes in unrecognized assets and debt from the beginning to the end of the period*

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:

	Debit	(Credit)	
(G)-1 (Balance Sheet)			
Inventories	$ -	-	**(e) = (b) x -1**
Current Deferred Tax Account	-	-	**(f) = (b) x (d)**
Retained Earnings	-	-	**(g) = [(e) + (f)] x -1**

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:

		(a)	(b)	(c)	
			Expense/Loss		
		Revenue/Gains	Taxable	Non-Taxable	
		Increase	Increase	Increase	
	Account Affected	(Decrease)	(Decrease)	(Decrease)	Description of Unusual Item

Net Pre-Tax Effect of Unusual/Non-Recurring Items	-	**(d)**	← Increase (Decrease) to EBIT [∑ Column (a) - ∑ Column (b) - ∑ Column (c)]
Income Tax Effect - (Increase) / Decrease to Income Tax Expense	-	**(e)**	← [∑ Column (a) - ∑ Column (b)] x (i) x -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:

	Debit	(Credit)	
(H)-1 (Income Statement)			
Unusual & Non-Recurring Items - Adjust. After-tax	-	-	**(f)**
Taxes	-	-	**(e) x -1**
	-	-	
	-	-	
Income Statement accounts to be adjusted →	-	-	
	-	-	
	-	-	
	-	-	

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:

	Account Affected	Effect on Net Operating	Description of Unusual Item

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

Step 2 - Adjustments:

	Inflow	Outflow	
(I)-1 (Cash Flow Statement)			
Unusual & Non-Recurring Items - Cash Flow Adjs	**-**	**-**	**(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:

Adjustment (J) - 1

Account Affected	(a) Assets Increase (Decrease)	(b) Liabilities Increase (Decrease)	(b) Equity Increase (Decrease)	(c) Revenue/Gains Increase (Decrease)	(d) Expense/Loss Taxable Increase (Decrease)	(e) Expense/Loss Non-Taxable Increase (Decrease)	(e) Net Income Before Unusual Increase (Decrease)
Balance Sheet or Income Statement	-	-	-	-	-	-	
accounts to be adjusted	-	-	-	-	-	-	
	-	-	-	-	-	-	
	-	-	-	-	-	-	
Retained Earnings			-				
Taxes					-		
Unusual & Non-Recurring Items Adjmts							-

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)

Hybrid Securities Analysis - New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities, November 2003 (#79991)

Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!, March 2005 (#91696)

Changing Paradigms: Revised Financial Reporting for Special Purpose Entities, May 2002 (#74947)

Special Comments:

Securitization and its Effect on the Credit Strength of Companies: Moody's Perspective 1987-2002, March 2002 (#74455)

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.

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Report Number: 96760

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