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S&P: USPF Enterprise Sectors Treatment Of Operating Leases Under FASB's ASU 2016-02 (ASC 842)

Background

S&P Global Ratings is updating the market with its views on the Financial Accounting Standard Board's (FASB) new standard, Leases (ASC-842), and its impact on audited financial statements of rated entities in the not-for-profit health care, higher education, charter schools, and public power and electric cooperative sectors, which S&P Global Ratings collectively refers to as enterprise sectors. With the standard now in effect for a greater number of rated entities that report under FASB standards, we are providing additional information on the treatment of operating leases under our enterprise sectors criteria. We had published an FAQ, "How New Accounting Rules Will Affect U.S. Enterprise Sectors," on March 11, 2019, on RatingsDirect and this update supersedes that commentary.

We will continue to review our approach to incorporating lease liabilities into our analysis of enterprise sectors pursuant to our criteria, particularly as governmental issuers in the enterprise sectors implement lease updates through the Governmental Accounting Standards Board (GASB) Statement No. 87-Leases after a substantial delay in the required implementation date (see last section, titled "How will GASB No. 87 impact our analytical approach to leases?") to fiscal years beginning after June 30, 2021. Since GASB No. 87 changes how leases are classified, effectively no longer recognizing the operating lease distinction, we will expect to maintain consistency and comparability across the two accounting standards, to the extent possible given nuances associated with each standard, as the enterprise sectors have entities that present financial statements under both FASB and GASB standards.

Not all of our rated FASB entities have incorporated the new lease standard, yet. In response to concerns of the impact that the Coronavirus (COVID-19) pandemic could have on stakeholders, the FASB released ASU 2020-05 in June 2020, which delayed the effective implementation dates for ASC 842 for certain public not-for-profit entities which had not yet issued financial statements reflecting adoption of the standard, which includes obligors that use conduit issuers, and all other not-for-profit entities. Early adoption continues to be permitted. While a number of entities we rate have adopted the standard, certain entities have not yet adopted the standard due to FASB's delay of the effective implementation date.

Frequently Asked Questions

Will the lease accounting requirements result in rating changes?

Lease accounting requirements enhance transparency and add to robustness of disclosures, but are generally not expected to result in rating changes, nor have they in the past for rated entities that have adopted the standard. While the financial statement presentation under ASC 842 provides more clarity on the actual value of the lease liability, the actual lease obligations incurred by rated entities largely have remained unchanged; therefore, the accounting standards update has not been viewed as a new credit factor. We believe the financial effect of existing operating leases has been

incorporated into our credit ratings and related analyses prior to the ASC 842 update.

How do we incorporate lease usage into our analysis of enterprise sector obligors?

We will assess lease usage by the following measures:

Health care. Operating lease liabilities are typically not included in our calculation of long-term debt and related ratios, and we continue to believe that our lease-adjusted maximum annual debt service (MADS) coverage metric appropriately captures lease utilization within our assessment of the financial profile. Further, as per our criteria, we retain the flexibility to make an analytical judgment as to whether a negative consideration is warranted for the entities where liabilities or off-balance-sheet financings, including operating leases, materially bring added risk to the financial profile when not fully captured in debt to capitalization or other financial metrics. While we recognize that in certain cases the audited presentation of operating lease expense may now encompass additional expenses, such as variable lease costs, in most instances we are able to adjust for this such that operating lease expense remains comparable with prior periods, which typically consisted solely of operating and short-term lease costs. To date, there have been no rating changes driven by the change in accounting for operating leases among rated not-for-profit health care entities that have adopted ASC 842.

Higher education. While our criteria treats capital leases as debt, we have not generally treated operating leases as debt and have not included them in our MADS burden or total debt ratios. However, we review an institution's operating leases and in cases where we deem those operating leases significant compared with debt, we have assessed them in some capacity (e.g., either by including them in the MADS burden or in total debt calculations). Pursuant to our criteria, we reserve the right to adjust aspects of the financial profile assessment in order to adequately capture the risk associated with elevated operating lease usage. Since implementation of FASB ASC 842 (applicable to private colleges and universities, independent schools and some public universities that elect to follow FASB accounting standards), none of our ratio definitions and their applications have changed and, related to this matter alone, there have not been any changes in our opinion of an institution's underlying creditworthiness.

Charter schools. Pursuant to our criteria, operating lease liabilities are typically not included in our calculation of long-term debt and related ratios. However, for charter schools, we have consistently incorporated the use of operating leases into our rating analysis through our use of lease-adjusted MADS when calculating key financial ratios, such as debt service coverage (DSC) and debt burden. For example, we calculate lease-adjusted MADS coverage as earnings before interest, depreciation, and amortization plus facility lease expense/MADS plus facility lease expense. Lease-adjusted MADS coverage is generally the heaviest weighted component of our financial profile assessment for rating charter school bonds. We reserve the right to adjust aspects of the financial profile assessment when we deem the lease-adjusted MADS coverage and debt burden to insufficiently capture the risk associated with elevated lease usage.

We will continue to analyze the effect of implementation on all entities that use operating leases and update our view of the underlying creditworthiness accordingly.

Public power and electric cooperatives. Our long-standing practice has been to treat lease agreements as having debt-like attributes irrespective of whether accounting standards dictate classifying power purchase agreements as finance or operating leases. We reflect these adjustments in our fixed-charge coverage calculations, which we perform in addition to our DSC calculations. Our fixed-charge coverage focuses on payments utilities make to utility suppliers to reserve generation capacity and to their retail customers. Because we are already capturing the dominant lease and lease-like payments in our fixed-charge coverage, we believe that the changes in accounting

standards do not affect coverage ratio analysis for public power and electric cooperative utilities.

When do we consider operating lease usage to be significant and compel additional adjustments to our standard ratios?

The analytic decision to make an additional adjustment within the financial profile assessment of an obligor could reflect various lease factors such as our view of the magnitude of the operating lease liability relative to the capital structure, structural elements of the leases, and the perceived strategic risk of the leasing strategy. In those instances where we believe these lease factors are not fully captured in our ratios, we reserve the flexibility in our criteria to apply a negative adjustment in the financial profile section of the criteria. While rare, there have been instances where we have applied a negative adjustment within the financial profile section of our criteria.

How do we expect accounting for leases to differ under FASB ASC 842 compared with GASB No. 87?

Based on our initial understanding of GASB No. 87, we expect that after its implementation, most lease arrangements previously classified as operating or capital leases, will be considered finance leases, which we typically include in long-term debt. Therefore, we believe this difference in lease accounting reporting requirements under GASB compared with FASB complicates the ability to separate lease liabilities from long-term debt. However, the underlying economics of lease arrangements are unchanged solely due to the new accounting standard, so we generally do not anticipate rating changes associated with the GASB No. 87 standard. We will review whether the presentation of GASB No. 87 requires us to revisit the details of how we incorporate operating leases into our criteria—specifically as it relates to debt and coverage-related ratios.

How will GASB No. 87 affect our analytical approach to leases?

We expect to maintain analytical consistency in our approach to evaluating lease obligations and to maintain comparability across rated entities within sectors regardless of whether the rated entities follow GASB or FASB accounting standards, to the extent possible given the incongruity of the two accounting pronouncements. While early adoption is permitted, to date, S&P Global Ratings has not seen the specifics of how GASB No. 87—applicable to most public colleges and universities, community colleges, hospital districts, public transportation, public housing, local governments, and public power entities—will present on financial statements.

More broadly, since the GASB update on leases will affect all USPF credits, we will update the market on our views regarding leases beyond the enterprise sectors, including all government entities in USPF.

This report does not constitute a rating action.

30 Jul, 2021