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# Corporate Methodology: Ratios And Adjustments

April 1, 2019

## Overview And Scope

This document provides additional information and guidance relating to the application of S&P Global Ratings "Corporate Methodology: Ratios And Adjustments" criteria published April 1, 2019. This guidance document is intended to be read in conjunction with that criteria or further explanation on guidance documents, please see the description at the end of this document.

## Guidance

- Our analytical adjustments are not generally affected by ongoing changes in accounting rules, but we may modify our analytical adjustments for a significant rule change to ensure our adjusted metrics remain consistent across accounting standards.
- Where financial information required for our analytical adjustments is not provided, we may request it from management or otherwise determine a best estimate.
- Sufficiently creditworthy:** For the purpose of our criteria, we would consider a company to be sufficiently creditworthy if it is rated in the investment grade category (i.e. BBB or higher).
- Nonrecurring items and pro forma figures:** The relative stability or volatility of a company's earnings and cash flows is an important measure of credit risk that is embedded in our corporate methodology. For this reason, our use of nonrecurring or pro forma adjustments is typically limited to when there has been some transformational change in a company's business. A transformational event is one that causes a material change in an entity's business or financial profile. Examples include the divestment of part of the business or a fundamental change in operating strategy.

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## Key Publication Information

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- 6 **Discontinued operations and business divestments:** We typically exclude profits, losses, and cash flows from discontinued operations from our metrics so that they more accurately reflect the company's ongoing operations.
- 7 **Pro forma accounts for intrayear acquisitions or irregular reporting periods:** If an acquisition has occurred, the financial statements for the year of the acquisition include all of the enlarged group's debt in the year-end balance sheet, but less than the acquired company's full year results and cash flows. Depending on the acquired company's size, this can distort debt coverage ratios, which therefore may not accurately indicate the company's key future performance. A similar issue exists when companies have irregular accounting periods, such as after a change in the reporting year end. In these cases, we may use pro forma financial statements to allow for a more representative measure of full year performance and more meaningful ratios.

### Scope of consolidation

- 8 When analyzing a group's creditworthiness, a first critical step is to determine how the results of subsidiaries and affiliates should be depicted in the parent's consolidated financial statements. This determination builds on our view of the group, including the relationship of the parent with its subsidiaries, as per our group rating methodology.
- 9 There are several accounting methods to reflect a company's relationship with another company (treating it as an investment, accounting for it under the equity method, fully consolidating it, etc.). Most often we use the same scope of consolidation as is used in the parent's consolidated financial statements. This is because accounting consolidation and the underlying analytical criteria of our group rating methodology both rely on the concept of "control," which refers to the parent's ability to dictate a group member's strategy and cash flow.
- 10 Several factors determine our analytical view of a company's relationship with a particular subsidiary or affiliate. These factors include strategic importance, whether there is control, percentage of ownership, key financial support, and whether there are other owners, and if so what rights those other owners have. The parent company's ability to control, direct, and benefit from the subsidiary's cash flows may also drive our decision on whether to accept the accounting consolidation.

Based on the above analyses, we may adjust the group's financial statements to better reflect our opinion on the underlying economic drivers of a company's business and financial ties with its subsidiaries or affiliates and the resulting benefits and obligations. We may also adjust the group's financial statements if the group includes businesses with very different business models and credit drivers. For example, we may deconsolidate the regulated banking operations of a retail parent to better understand, analyze, and reflect the credit quality of the two separate businesses, even though we may consider both to be part of the same wider group, and we would treat them as per our group rating methodology.

- 12 In certain cases, fully consolidating used in the financial statements may not reflect our view of the group's underlying leverage or controlled cash flows due to significant minority shareholders in the subsidiaries. In these cases we will use other consolidation methods (such as proportionate consolidation) to estimate key credit metrics.

## Adjustments For Key Principles

- 3 We apply four key principles in our adjustments to reported financial data: the adjusted debt, adjusted earnings, adjusted cash flow, and adjusted interest principles. The summary tables under each section of our key principles illustrate the routine adjustments for each one. Additionally, we may apply statutory and sector specific adjustments in each category.

### Adjusted debt principle

- 4 We calculate adjusted debt as follows:

Reported debt	
	Access to cash and liquid investments
+	Leases
+	PP&E and deferred compensation
+	AROs
+	Securitization sales and factoring of trade receivables and other assets
+/-	Hybrid capital instruments
+	Financial guarantees
+	Earnings and deferred consideration for business acquisitions
Adjusted debt	

- 5 We typically measure certain long-term liabilities that do not bear explicit interest payments by calculating the net present value of the liabilities using a discount rate. For instance, minimum non-cancelable operating lease commitments are discounted at 7% for companies that do not capitalize operating leases on the balance sheet. For other liabilities, such as bonds or loans that pay interest, the amortized cost basis of measurement captures the discounting impact of the debt principle.
- 6 **Adjustment to debt for non-executory contracts:** We may treat as debt certain non-executory contracts such as take-or-pay contracts. In certain situations, these contracts provide benefits of future price protection to the buyer in exchange for an unconditional minimum purchase obligation to the seller. This is primarily because the seller takes on much of the price risk and non-performance risk by the buyer.
- 7 **Adjustment to debt for redeemable common stock held by minority shareholders:** We add the liability derived from a redeemable minority interest when the redemption is outside of the issuer's control (for example, the minority interest holder has a put option on the subsidiary shares as opposed to the issuer having a call option to repurchase the shares) and we fully consolidate the subsidiary in our analysis. The liability would be added to our adjusted debt figure based on the adjusted debt principle since the subsidiary is fully consolidated in our metrics and, therefore, the benefits of ownership are accruing to the issuer. We may take a different view depending upon the facts and circumstances if we judge that the option is very unlikely to be exercised.

- 8 **Structured settlements of dispute:** We include non-adjusted debt (on a discounted basis if feasible) that is related to structured settlements of dispute, whether with commercial or governmental entities. For example, we add tax and tobacco settlements to debt because they are "incurred" liabilities that provide no future offsetting operating benefit."
- 9 **Shares other than common stock** We will not add classes of shares to our adjusted debt measures, regardless of the denomination, if they will never require any cash payments or cause any credit stress and if they comply with all of the following conditions:
  - No stated coupon or yield;
  - No maturity;
  - No ability to redeem for cash (but could be converted into common stock);
  - No covenants or events of default;
  - No security or guarantees; and
  - Subordination to all debt.
- 20 This provision would also apply to shares that comply with all of the above characteristics as so include one or both of the following:
  - A preference in liquidation to other common stock; and/or
  - A preference in the distribution of dividends when dividends are declared, but no entitlement to dividends otherwise. This would be the case, for example, if when dividends are declared there is an agreement among shareholders about how those dividends are distributed. We would not include in this provision shares that carry a dividend that can be deferred, whether cumulative or non-cumulative. These instruments are typically covered by our hybrid criteria.
- 21 However, we will add to our adjusted debt measures shares that are subject to a put option or other economic adjustment mechanism (except if the put option can only be exercised upon an initial public offering).
- 22 Shares other than common equity provided by controlling shareholders should be analyzed under our non-common equity criteria.

**Adjusted earnings principle**

23 We calculate adjusted EBITDA as follows:

<b>Reported revenue</b>
Operating expenses
+ Depreciation
+ Amortization
+ Non-current asset impairment and impairment reversals
+ Cash dividends received from equity accounted affiliates (we exclude the profits or losses from such affiliates)
+ Equity settled stock compensation
Capitalized development costs
+ Adjustments for leases
+/- Adjustments for PRBs and deferred compensation

Adjustments for AROs
+/- Adjustments for earnings and deferred consideration for business acquisitions
<b>Adjusted EBITDA</b>

24 We calculate adjusted funds from operations ( FFO) as follows:

<b>Adjusted EBITDA</b>
Cash interest paid adjusted
Cash taxes paid
<b>Adjusted FFO</b>

### Operating and non-operating items

- 25 Our calculation of EBITDA and FFO generally includes items that we consider to be operating in nature (rather than investing or financing in nature) and excludes non-operating items. Most often, our views consistent with how accounting standards classify these items in the statement of cash flows. Below are examples of how we apply our adjusted earnings principle to various scenarios to determine whether transactions are operating or non-operating. The adjustments below are routinely made to all companies where applicable and material.
- 26 **Disposals:** We typically view the disposal of a subsidiary or the sale of property, plant, and equipment as outside core business operations. As such, we generally do not treat these transactions as an operating activity and exclude any gain or loss from our calculation of EBITDA and FFO.
- 27 **Restructuring costs:** Our calculation of EBITDA typically includes restructuring costs (which reduce EBITDA), including those that will be settled in cash in the future. We typically view restructuring costs as an operating item because most companies need to restructure their operations to adapt to changing environments and remain competitive and viable.
- 28 **Acquisition-related costs:** Our EBITDA calculation includes acquisition-related costs including advisory, legal, and other professional and administrative fees related to an acquisition. Many businesses make acquisitions as part of their growth strategy; therefore, it is important to factor these expenses into EBITDA.
- 29 **Asset impairments/write-downs:** We exclude impairment costs or reversals on tangible and intangible noncurrent assets from our definition of EBITDA because they are akin to depreciation or amortization costs in that they represent a company's income statement recognition of earlier capital expenditures. However, we include impairment costs on current assets, such as inventory and trade receivables because the charges for inventory represent a company's recognition in the income statement of money that it has already spent, and those for trade receivables represent the reduction of revenue and income previously recognized but that the company will not fully collect. Our definition of EBITDA generally includes impairment charges or reversals, except we may adjust for very large and irregular impairments or impairment reversals of non-current assets.
- 30 **Foreign currency transaction gains and losses:** We may view foreign currency transaction gains and losses as operating (and therefore include them in EBITDA and FFO) or non-operating in nature. For example, if material, we exclude foreign currency gains or losses resulting from the

issuance of foreign currency denominated debt from EBITDA and 0 of those gains or losses are shown as operating items.

- 3 **Unrealized fair value movements:** When disclosed, we typically reverse the impact of unrealized fair value gains and losses from EBITDA and 0. Examples of these items include:

- Unrealized fair value gains or losses on investment properties under International Finance Reporting Standards (IFRS);
- Changes in value of earnout liabilities; or
- Unrealized gains and losses on derivatives.

### Adjusted cash flow principle

- 32 We calculate adjusted cash flow from operations (CFO), adjusted free operating cash flow (FOCF), and adjusted discretionary cash flow (DCF) as follows:

Reported CFO
+/- Interest or dividends received and interest paid reported outside of CFO
Capitalized interest
Capitalized development costs
+/- Adjustments for restructuring charges and factoring of trade receivables and other assets
+/- Adjustments for leases
+/- Adjustments for hybrid capital instruments
+/- Adjustments for earnings and deferred consideration for business acquisitions
Adjusted CFO
Adjusted capitalized expenditures
Adjusted FOCF
Cash dividends (paid on common and preferred stock)
Share buybacks
Adjusted DCF

- 33 Capital expenditures include funds spent to acquire or develop tangible and intangible assets. We make adjustments to reported capital expenditures for capitalized development costs and capitalized interest.

### Adjusted interest principle

- 34 We calculate adjusted interest as follows:

Reported interest expense on gross financial debt*
+ Amortization of discounts on debt issuance fees
+ Non-cash interest on convertible debt instruments (plus any interest on hybrid capital instruments shareholdings and non-common equity)
+ Capitalized interest

+ ease interest
+ PRB interest
+ ARO interest
+ Realized effects of interest hedging derivatives
Unrealized favorable movements of interest derivatives
<b>Adjusted interest expense</b>

Note: In our calculation of adjusted interest expense + or - indicates that we include or exclude items that may or may not already be reflected in the reported interest expense.

35 Our adjusted interest principle is based on an accrual based interest expense and is primarily used to calculate the EBITDA to interest coverage ratio. However, we use the reported cash interest plus or minus applicable adjustments to calculate EBITDA cash interest coverage.

## Routine Analytical Adjustments

### Accessible cash and liquid investments

36 We identify cash and liquid investments as accessible when, for example, they are:

Heid in a nonconvertible currency to the currency of a company's borrowings;

Subject to default or restrictions (for example, cash and investments held in escrow, unless they are restricted to support obligations that we include in debt);

Trapped in subsidiaries (as we believe that cash may not be moved out of the subsidiary at short notice to repay debt elsewhere in the group; however, cash at a subsidiary that meets our criteria for netting may be netted against adjusted debt at that subsidiary);

Required to fund tax payable on repatriating cash or liquidating an asset; or

Held specifically on behalf of third parties (such as governments, customers, etc.).

37 In addition, we will assess whether there are risks of exchange or capital controls in the company's home country, or in the country or countries where its subsidiaries are located, that should be reflected in the calculation of accessible cash.

38 We will generally not deduct accessible cash and liquid investments (accessible cash) from debt if a company is owned by a financial sponsor or has a business risk profile assessment of weak or vulnerable (both concepts defined in our "Corporate Methodology"). However, we deduct accessible cash from debt even if a company meets either of these conditions, as long as:

We believe that the company has accessible cash earmarked to retire maturing debt or other debt-like obligations; and

We believe typically from the company's track record, market conditions, or financial policy that management will use the cash to pay off maturing debt or debt-like obligations.

39 Cash held in escrow for the debt holders' benefit would be fully netted off from debt if the debt is included in our debt calculation.

40 When calculating accessible cash, we typically do not reduce cash and liquid investments by the amount of expected working capital investment needs. This is because this would disadvantage

companies that fund working capital from cash rather than by drawing down on bank lines.

- 41 In rare cases, we may exclude from access to cash unusually large portions of cash physically trapped in the usual course of business. Some examples of this include a supermarket that has an unusually large amount of "cash in tills," or a casino that has a higher than typical amount of "cash in cages."

- 42 Data requirements:

The amount, term, location, quantity, and other characteristics of access to cash.

- 43 Calculation:

Debt: We reduce debt by the amount of access to cash.

## Leases

- 44 We generally accept the balance sheet treatment for companies that capitalize leases on the balance sheet, such as U.S. Generally Accepted Accounting Principles (GAAP) and RSFRS, by including the reported lease obligations in our adjusted debt. In certain circumstances we may adjust the amount added to adjusted debt to better reflect the lease average (see below).
- 45 For U.S. GAAP firms that capitalize leases, we also adjust our income statement and cash flow measures to remove the distinction between finance leases and operating leases.
- 46 For those entities not required to capitalize operating leases on balance sheet, we will adjust our debt, earnings, interest, and cash flow measures for operating lease reporting. To calculate the adjustment to debt for operating leases that are not reported on balance sheet, we calculate a present value of the future lease payments using a 7% discount rate. We may update our discount rate in the future based on data and trends observed from entities that have reported operating leases on the balance sheets.
- 47 We net sublease rental income from future lease payments on the lease and sublease terms match and we believe the holder of the sublease is sufficiently creditworthy (as previously defined).
- 48 We do not adjust capital expenditures, and therefore EOC, for any imputed capital expenditures relating to leases.
- 49 **Leases with artificially short terms** In certain cases we may adjust the lease amount added to our measure of debt to better reflect the lease average, for example if we view the remaining lease terms as artificially short relative to the expected use of the leased asset. Our expectations that, in most cases, the reported lease obligations should be at least three times the next 2 months lease commitments. If they are below this level, we may increase the reported lease obligations to at least three times and reflect that impact in the other metrics affected by the lease adjustment.
- 50 The three times multiple is not a hard measure, and analyst judgment is applied. We may increase the liability above three times in certain instances, such as to enhance comparability in lease-intensive sectors. Further investigation may indicate that no upward adjustment is required. For example, if a company's on-site significant lease with a remaining lease term of two years was for a non-core asset that would not be needed after two years due to a change in the company's business model, then no upward adjustment would be necessary.
- 51 **Other lease-like contracts** In rare cases, we also adjust lease obligations (such as when companies characterize lease contracts as service contracts), because we believe the reported amounts do not adequately capture the transactions underlying economics. In such cases, we may also carry



through this adjustment to our other metrics, if appropriate.

<sup>52</sup> Data requirements:

or RS companies for which RS 6 is adopted:

Reported lease obligations on the balance sheet (both the current and noncurrent portions)  
or U.S. GAAP companies for which ASC Topic 842 is adopted:

Reported finance lease obligations on the balance sheet (current and noncurrent portions).

Reported operating lease obligations on the balance sheet (current and noncurrent portions).

Reported operating lease cost for the most recent income statement.

Reported weighted average operating lease discount rate.

or companies that have not yet adopted or do not report under the above lease accounting standards:

Minimum lease payments: The schedule of non-cancelable future lease payments over the next five years and beyond.

Reported finance lease obligations on the balance sheet (current and non-current portions).

Reported annual lease related operating expenses for the most recent year.

The annual operating lease related expense, which we estimate using the average of the first projected annual payment disclosed at the end of the most recent year and the previous year.

<sup>53</sup> Calculations:

or RS companies for which RS 6 is effective:

Debt: We include the reported amount of lease obligations in adjusted debt.

Interest expense: We reclassify any lease interest as an operating cash flow under RS 6 and is presented as part of the investing or financing section of the statement of cash flows.

or U.S. GAAP companies for which ASC Topic 842 is effective:

Debt: We include the reported amount of lease obligations in adjusted debt.

Income statement and cash flow measures: The reported operating lease cost is allocated to interest and depreciation expenses. EBITDA is increased by adding back the interest and depreciation expenses. EBIT is increased by adding back the interest expense. COGS is increased by adding back the depreciation expense (which we use as a proxy for the capital repayment portion of the lease). OI is decreased by the operating lease interest expense (as a proxy for cash interest).

Interest expense: The interest expense is increased by multiplying the average operating lease obligation for the current and previous year by the reported weighted average operating lease discount rate.

Depreciation expense: The depreciation expense is increased by the difference between the reported operating lease cost and the calculated interest expense.

or companies that have not yet adopted or do not report under the above lease accounting standards:

Debt: For operating leases, we add the present value of future lease payments to debt, calculated using a 7% discount rate. Since minimum lease payments beyond the fifth year are regularly disclosed in aggregate as "thereafter," our methodology assumes that annual payments beyond the fifth year equal the payment amount in year five, and that the number of years in the "thereafter" period equals the "thereafter" amount divided by the fifth year

amount, rounded to the nearest year. This assumption is capped at a total payment profile of 30 years.

Debt: For finance leases, if they are not already included in reported debt, we add reported finance lease obligations to debt.

Total assets: We add the amount of operating leases we reclassify as debt to total assets to approximate the depreciated asset cost.

Income statement and cash flow measures: The lease related expense is allocated to interest and depreciation expenses. EBITDA is increased by adding back the interest and depreciation expenses. EBIT is increased by adding back the interest expense. CO is increased by adding back the depreciation expense (which we use as a proxy for the capital repayment portion of the lease). O is decreased by the operating lease interest expense (as a proxy for cash interest).

Interest expense: The interest expense is increased by the product of the 7% discount rate multiplied by the average net present value of the lease payments for the current and previous year.

## Postretirement employee benefits and deferred compensation

- 54 **Adjustments to debt** We include underfunded defined benefit obligations for retirees, including pensions and health care coverage (collectively, PRB) in our measure of adjusted debt because they represent financial obligations that must be paid over time. Our calculation of PRB includes other forms of deferred compensation like retiree lump sum payment schemes and long service awards, but not defined contribution obligations.
- 55 To calculate the amount we add to debt, we aggregate all retiree benefit plan assets and liabilities for pensions, health, and other obligations and net the positions of a company's plans in surplus against those that are in deficit on an after-tax basis. Adjusted debt is not reduced if there are net surpluses.
- 56 We tax effect our PRB adjustment amounts (that is, give credit for associated future tax benefits), unless the related tax benefits have already been, or are unlikely to be, realized. We use the tax rates applicable to the company's plans (e.g. reported deferred tax asset) or the current or future expected corporate rate. We do not tax effect the adjustment amounts if we consider a company's ability to generate taxable profits uncertain.
- 57 **Adjustments to the income statement** Under IFRS, the period's current service cost reflecting the present value of future benefits employees earned for services rendered during the period is the sole item we keep as part of operating expenses. We view the interest expense as a finance charge and reclassify it as such if reported differently. We do not adjust the pension expense under U.S. GAAP because current service costs are already the sole item in reported operating expenses.
- 58 Under U.S. GAAP, in addition to interest expense, the expected return on plan assets is a separate disclosed and represents the company's subjective, long-range expectation about investment portfolio returns. We use the reported interest expense and expected return on plan assets to arrive at PRB interest. This concept of expected return has been abandoned under IFRS, which calculates a net interest figure by multiplying the deficit (or surplus) on the PRB by the discount rate.
- 59 Under both U.S. GAAP and IFRS, these measures of PRB interest, if a net expense, are added to reported interest. No adjustment is made if net interest is a net income item.

60 Data requirements:  
or adjustments to income statement:

Service cost;

Interest cost;

Expected return on pension plan assets, if applicable;

Other amounts included in earnings (such as actuarial gains or losses, prior service costs, special benefits, settlements, and curtailments of benefits); and

Total benefit costs.

or adjustments to balance sheet items:

Deferred tax assets related to PRB (or the tax rate applicable to related costs);

Carrying amount of pension assets; and

Total pension liabilities.

61 Calculations:  
or adjustments to income statement:

Operating income: Add to EBIT and EBITDA the total amount of PRB costs charged to operating income, less the current service cost for companies that do not report under U.S. GAAP.

Interest: PRB interest is the net interest cost as reported by companies under IFRS, or interest expense less expected return on pension assets for companies under U.S. GAAP. If PRB interest is a cost, we include the net adjusted interest expense (we do not reduce interest expense if PRB interest is an income item).

or adjustments to balance sheet items:

Debt: The net balance sheet asset or liability position (or funded status) is calculated as the balance sheet PRB assets minus PRB liabilities. If the funded status is positive, debt is not adjusted. If the funded status is negative, this amount is tax-effected and added to debt.

In some jurisdictions, the tax benefits are realized before funding the deficit or paying benefits, for example, when the liability is accrued for tax purposes. In such cases, the expected tax benefit on any includes tax benefits that have not yet been received.

## Asset-retirement obligations

62 Asset retirement obligations (AROs) or decommissioning liabilities are legal obligations associated with a company's retirement of tangible long-term assets. Examples of AROs include the cost of plugging and dismantling oil and gas wells, decommissioning nuclear power plants, treating or storing spent nuclear fuel, and capping and restoring mining and waste disposal sites.

63 We add AROs to debt after deducting any dedicated retirement fund assets or provisions, savings value, and anticipated tax benefits. We use the tax rates applicable to the ARO (e.g. reported deferred tax asset) or the current corporate rate to calculate the anticipated tax benefits.

64 We generally use the reported ARO figures, but we may make adjustments if we believe any of the company's assumptions are unrealistic. Those assumptions may include the ultimate cost of abandoning an asset, the timing of asset retirement, and the discount rate used to calculate the balance sheet value.

65 In certain situations, companies fund AROs by adding a surcharge to customer prices, or the AROs will be paid by third parties such as a state-related body. In these cases there would typically be

no debt adjustment.

66 The reported accretion of an ARO is taken to noncash interest and is similar to PRB interest charges. Accordingly, we recalculate the accretion (net of reported earnings on any dedicated ARO funds) as interest expense.

67 Data requirements:

The ARO figure (from the financial statements or our estimate).

Any associated assets set aside for AROs.

ARO interest costs (and whether charged to operating or financing costs).

The reported gain or loss on assets set aside for funding AROs.

68 Calculations:

Debt: Add net ARO to debt (net ARO is the reported or estimated ARO less any assets set aside to fund AROs, multiplied by minus the corporate tax rate or less the reported deferred tax asset).

EB TDA and EBITDA: Add ARO interest costs included in operating costs.

Interest expense: Deduct ARO interest costs (net of ARO fund earnings) from reported operating expenses, if included there, and add to interest expense.

## Capitalized development costs

69 We deduct from EB TDA, EBITDA, and EBIT the amount of development costs capitalized during the year. However, where not available, we may use the related annual amortization reported in the financial statements as a proxy for the current year's development costs. We adjust EBIT for the difference between the capitalized development costs and the amortization.

70 In the statement of cash flows, we recalculate capitalized development costs from investing to operating cash flow, reducing operating cash flow and capital expenditures so that free cash flow remains unchanged.

71 **Software development costs:** While U.S. GAAP generally treats development costs as an expense, it has specific exceptions that allow the expenses to be capitalized, which is similar to IFRS. These exceptions include both software developed for internal use and software developed for sale to third parties. For companies that develop software primarily to sell to external parties, we use the technology software and services industry sector specific adjustment to determine how to treat capitalized software development costs. For companies with a business model that typically does not involve selling software to external third parties, we generally assume that all capitalized software development costs are for internal use, unless we have specific information leading us to believe otherwise. As a result, for these companies, we do not adjust for these costs in EB TDA and EBITDA. We do this for comparability between those companies that develop software for internal use and those that purchase software and equivalent products and capitalize them.

72 Data requirements:

Amount of development costs incurred and capitalized during the period, excluding, if practicable, capitalized development costs for internal use software.

Amortization amount for relevant capitalized costs.

## 73 Calculation:

EB TDA,  $\Delta$ , and C O: Subtract the amount of capitalized development costs, or, the amortization amount for that period.

EB T: Subtract (or add) the difference between the spending and amortization in the period.

Capital expenditures: Subtract the amount capitalized in the period.

**Securitization, sale, and factoring of receivables and other assets**

74 We typically adjust debt for securitization, sale and factoring of receivables and other assets (collectively called securitizations), reflecting our view that many assets securitized, sold, or factored (such as trade receivables) are regenerated in the ordinary course of business and need to be financed on an ongoing basis. That is, the assets and trading relationships these assets represent are an integral part of a company's operations. If a company has a recurring need to finance similar assets, we do not presume it will have permanent access to the securitization market, and it may have to meet future funding needs by other means.

75 In certain cases, we may not treat securitizations as a financing. For example, we may not make a debt adjustment when the securitized assets are not regenerated in the ordinary course of business and when we view the securitization as equivalent to an asset sale, for example in the securitization of a tax asset. We view such securitizations as equivalent to an asset sale, for example, if the company retains none of the risk and is not considered likely to support the transaction through moral recourse (this refers to the likelihood that a company will support a securitization even though it is not legally obligated to do so) and there are no contingent or indirect attributes resulting from the transaction.

76 Under U.S. GAAP and IFRS, companies report cash inflows or outflows related to working capital assets or liabilities, or finance receivables, as operating cash flows. Consequently, securitizations of assets such as receivables affect C O and the effect may be particularly significant in report periods when the securitizations are initiated or mature. When we adjust debt for a securitization, we also adjust C O to reverse the impact of any cash flows related to the securitization.

77 In some transactions, companies receive a beneficial (or retained) interest in the securitized assets in addition to cash upon the sale of the assets. Any future cash the company receives for beneficial interests is presented as an investment cash flow under U.S. GAAP. Other accounting regimes treat these receipts as an operating cash flow. For consistency, we typically add the cash received for beneficial interests to operating cash flows for U.S. GAAP companies.

## 78 Data requirements:

The period-end amount of trade receivables sold or securitized, as well as all other securitized assets that are not reported on the balance sheet and require adjustments according to our criteria.

## 79 Calculation:

Assets: Add the amount of period-end trade receivables sold or securitized (that is, the uncollected receivables as of the balance sheet date) to reported receivables. While the assets securitized are most often receivables, we may also add the securitizations of other assets to total assets.

Debt: Add the amount of period-end securitized assets to reported debt.

C O: Reverse the impact of cash flow movements from the initiation of a securitization,

subsequent changes in amounts secured, or the securitization maturity. Rolling over an existing securitization requires no cash flow adjustment. Where beneficial interests are reported as an investing cash flow (U.S. GAAP), we reclassify them as operating cash flows.

**Hybrid capital instruments**

80 We make adjustments for hybrid capital instruments based on our determination of the equity content:

Hybrids that have high equity content are excluded from adjusted debt and the interest or dividends are treated as dividends.

For hybrids with intermediate equity content, 50% of the principal is treated as debt and 50% is excluded from adjusted debt (excluding unpaid accrued interest or dividends, which are added to debt). Similarly, we treat one-half of the periodic interest or dividends as dividends and one-half as interest. There is no adjustment to related taxes.

Hybrids with no equity content are treated as debt and all interest or dividends are treated as interest.

81 The nominal value of hybrid instruments eligible to achieve intermediate or high equity content is typically limited to a percentage of a corporate issuer's capitalization (the application of this is described in our hybrid capital criteria). For example, assuming a 5% limit, if we calculate capitalization to be €1 billion, then hybrid instruments with a nominal value of up to €50 million could be eligible to achieve intermediate equity content, meaning we could deduct €75 million from debt (assuming they were originally reported as debt).

82 We define capitalization as follows:

<b>Balance sheet adjusted equity (excluding hybrid)</b>
+ Adjusted debt (before hybrid adjustment)
+ Hybrids as reported
Goodwill greater than 0% of total adjusted assets (before goodwill adjustment)
<b>Capitalization</b>

83 To calculate the percentage described above, the numerator excludes bonds that are mandatorily convertible into shares but includes hybrids to which we assign no equity content. Both amounts are included in the value of capitalization.

84 In all cases, deferred cumulative interest or dividend payments are included in adjusted debt.

85 Data requirements:

Amount of hybrids, debt, goodwill, and shareholders' equity on the balance sheet.

Amount of associated interest or dividend expense and interest or dividend payments in the period.

Amount of unpaid accrued interest or dividends.

Total adjusted assets (reported total assets plus or minus applicable adjustments).

86 Calculations:

Hybrids reported as equity: ( ) If we classify equity content as high, there is no adjustment to

equity. (2) if we classify equity content as intermedate, we deduct 50% of the value from equity and add it to debt. We deduct 50% of the dividend accrued during the accounting period and add it to interest expense. We deduct 50% of the dividend payment in the period from O and CO. (3) if we assign no equity content, we deduct the full principal amount from equity and add it to debt. We add associated dividends to interest expense. We deduct dividends paid from O and CO.

Hybrids reported as debt: ( ) We deduct the value of hybrids with high equity content from debt and add it to equity. We deduct the associated interest charge from interest expense and add it to dividends. We add back the associated interest payment to O and CO. (2) if we classify equity content as intermedate, we deduct 50% of its value from debt and add it to equity. We also deduct 50% of the associated interest charge from interest expense and add it to dividends accrued. We add 50% of the dividend payment in the period to O and CO. (3) if we assign no equity content there is no adjustment because we treat such hybrids as debt.

## Capitalized interest

87 In the statement of cash flows, we reclassify any capitalized interest shown as an investing cash flow to operating cash flow. This adjustment reduces CO and capital expenditures by the amount of interest capitalized in the period. OCI remains unchanged.

88 Data requirements:

The amount of capitalized interest during the period.

89 Calculations:

Interest expense: Add amount of interest capitalized during the period.

O, CO, and capital expenditures: Subtract the amount of capitalized interest recorded as an investing cash flow.

## Financial guarantees

90 We may not add the fully guaranteed amount to debt if, should the guarantee be called, the net amount payable would be lower than the guaranteed amount. This could happen, for example, if the company that has provided the guarantee has been counter-guaranteed by another party, that we view as sufficiently creditworthy. In this case, we add the lower amount to debt.

91 Data requirements:

The value of financial guarantees on and off the balance sheet, net of any tax benefit.

92 Calculations:

Debt: Add to debt the amount of on and off balance sheet debt equivalent related to financial guarantees, net of any tax benefit.

## Earn outs and deferred consideration for business acquisitions

93 We treat as debt contingent and deferred consideration that is payable in cash, and consideration to be settled in shares that does not qualify as equity. The most common example of the latter is a contract to be settled with a variable number of shares. Companies typically record such

arrangements, net a liability at fair value and then subsequently mark them to market at the end of each accounting period through charges or credits to income until settled. We add to debt the reported value of the liability classified contingent consideration on each reporting date, understanding that this is not at amortized cost.

94 Contingent arrangements that require continued employment are technically not part of the consideration paid for the acquisition under U.S. GAAP and IFRS. Rather, these transactions represent remuneration for services after the acquisition. As such, the company does not record the transaction as a liability or expense until the services are performed. We also view such arrangements as payment for services and generally make no analytical adjustments.

95 We exclude the unrealized fair value changes of contingent consideration from EB TDA. In the rare cases where cash settlements are reported in CO, we remove the outflow because we consider an investment activity (the acquisition of businesses).

96 Data requirements:

The carrying value of deferred consideration or liability classified contingent consideration on the balance sheet date.

Charges or credits included in reported EB TDA.

Cash paid for or received from the settlement of contingent consideration reported in cash flows from operating activities.

97 Calculations:

Debt: Add to debt, if not already reported as such, the carrying amount of deferred consideration at amortized cost, as well as any liability classified contingent consideration reported at fair value.

EB TDA: If charges or credits from the change in fair value of contingent consideration are included in reported EB TDA, add them back to or subtract them from EB TDA.

CO: In the rare cases where cash settlements are reported in CO, remove the outflow.

## Situational Adjustments

98 Our situational adjustments seek to capture the impact of a company's transactions when we believe they will significantly affect a company's credit metrics. We use analytical judgement to determine if a transaction should result in a situational adjustment.

99 Accounting distortions: In rare circumstances, we may make adjustments to exclude from our financial measures transactions that we view as accounting distortions. An example would be an adjustment to EB TDA to remove the change in a material litigation provision that leads to a very significant gain or loss in the year.

00 Litigation and other contingent liabilities: When we adjust for these liabilities, we add the estimated or actual amount of the exposure (net of any applicable tax deduction) to reported debt.

0 Workers' compensation and self-insurance claims: When we adjust for these liabilities, we add the amount recognized for workers' compensation obligations (net of tax) or the net amount recognized for self-insurance claims (net of tax) to debt.

02 Multi-employer pension plans: Some companies in the U.S. and the Europe, Middle East, and Africa region participate in multi-employer, defined benefit pension plans on the employees' behalf. If the liability associated with a funding deficit on multi-employer pension plans is very



significant and it is practically to do so, we may treat the liability as debt, as we do with definitions on significant employee defined benefit, postretirement obligations. When we make the adjustment, we obtain an estimate of the share of funding deficit or the withdrawal liability for each plan in which a company participates, and we add the estimated amount for all plans, net of tax, to debt.

<sup>03</sup> Foreign currency hedges of debt principle: We retranslated foreign currency denominated debt using the foreign exchange rate locked in by the hedge (or adjust the balance sheet value of debt to equal the hedged principle value). Alternatively, if the principles are not disclosed, we may add to or subtract from reported debt the fair value of the hedging instrument on the balance sheet date.

<sup>04</sup> Adjustment to debt for the deemed repayment liability under the 2017 revised U.S. corporate tax code: Under the adjusted debt principle, items that we add to reported debt include incurred liabilities that provide no future offsetting operating benefit. The deemed repayment liability that the 2017 revised U.S. corporate tax code creates for U.S. corporate issuers is such a liability, in our view. We will therefore typically include this liability, where material, in our adjusted debt. Under the new tax law, companies that are subject to the repayment liability may pay the entire lump sum or spread it out over eight years. If an issuer chooses to pay the liability over time, we typically add to debt the liability's net present value (NPV). To enhance consistency and comparability with other adjustments we make to debt, we typically use a discount rate of 7% when calculating the NPV.

## Sector-Specific Adjustments

<sup>05</sup> We use our sector-specific adjustments to reflect the impact of unique industry characteristics on a company's adjusted financial metrics. These sector-specific adjustments are consistent with our four adjustment principles, and are made where applicable and material.

## Sector-specific guidance

Aerospace and defense

Agriculture and commodity foods

Agriculture cooperatives

Branded nondurables

Capital finance operations

Commodity trading

Financial market infrastructures

Forest and paper products

Homebuilders and real estate developers

Media and entertainment

Metals and mining upstream

Oil and gas exploration and production

Refining and marketing

Food services and equipment

Operating leasing  
Real estate (REITs)  
Regulated utilities  
Retail and restaurants (auto retailers)  
Technology software and services  
Telecommunications and cable  
Transportation cyclical (airlines, shipping, and trucking)  
Transportation infrastructure

## Aerospace and defense

- <sup>06</sup> **PRB costs recovery under government contracts** Costs for PRBs (both pensions and others such as health insurance) are allowable costs under some U.S. government contracts (including the U.S. Foreign Military Sales program). Therefore, defense contractors, as well as the subcontractors (including firms based outside the U.S.), can generally recover these costs through pricing in the U.S. government contracts, with some limitations and calculation/timing differences. We reduce the PRB liability for the ability to recover these costs. We could also apply this adjustment to government contracts in other countries where a similar mechanism exists.
- <sup>07</sup> Defense contracts come in two general types: fixed price, where the contractor provides a product or service for an agreed price and is responsible for any cost overruns, and cost plus, where the contractor is reimbursed for all of its allowable costs (sometimes with a limit) plus a fee.
- <sup>08</sup> We believe defense contractors should be able to recover all of the PRB costs under cost plus contracts over time. However, we estimate that under fixed price contracts the contractor would only be able to recover increased costs when a new contract is awarded. Competitive pressures may make it difficult for the contractor to add the full costs to the new contract. Therefore, we estimate only 50% of these costs can be recovered under fixed price contracts over time.
- <sup>09</sup> The data needed to make the adjustment are:
- Percentage of revenues derived from U.S. government contracts (A)
  - Percentage of contracts that are fixed price (B) and cost plus (C)
- <sup>10</sup> We reduce our standard adjustments to debt for PRBs by the following percentage:  
 $A \times [(B \times 50\%) - (C)]$

## Agribusiness and commodity foods

**Biological assets:** Under some accounting regimes, agricultural assets may be marked to market on the balance sheet with the fair value gains and losses recognized in the profit and loss statements. In these instances, we typically exclude these non-cash gains and losses from our measures of EBITDA and EBIT, and make adjustments as necessary.

- <sup>2</sup> **Adjusted readily marketable inventories (ARMI):** For agribusiness and commodity food companies with significant commodity trading activities (defined as representing more than 10% of expected normalized EBIT, EBITDA, or gross margin), we apply the same adjustments for readily marketable inventories as we do for commodity traders to reflect the highly liquid nature of

certain physical commodity trading inventory. (See the Commodities Trading section for more details on ARM.) As such, for these companies we deduct ARM from our adjusted debt figures, even for agricultural business companies with significant trading operations that have a weaker overall business risk profile assessment.

## Agricultural cooperatives

- 3 We make the same adjustments for ARM and biological assets as in the agricultural and commodity foods section.
- 4 **Marketing cooperative cost of sales and member payment adjustments:** Marketing cooperatives may account for the cost of the commodity input they are marketing in a variety of ways, depending on the marketed commodity and accounting standards applied. Therefore, to increase comparability, in certain circumstances we adjust the reported cost of goods sold. This includes:
  - Cooperatives where the assigned value of sold inventory is deemed to be materially different than market value.
  - Cooperatives that do not assign a value to inputs received from patrons.
  - Cooperatives that measure the inventory using the net realizable value method.
- 5 Agricultural marketing cooperatives often operate on what is known as a pooling basis. This is where a marketing cooperative receives its members' agricultural products without obligation to pay a fixed price and commingles those products for processing and marketing purposes. The ability of marketing cooperatives operating on a pooling basis to determine appropriate transfer prices of product deliveries from patrons varies, and this can affect the financial reporting. Sometimes there is a good basis for recording product transfers between patrons and the cooperative. For example, dairy cooperatives often record product transfers using market order prices. They will assign values to the product received and therefore the inventory and resulting cost of goods sold reflects these assigned values. These assigned values generally represent market value and, therefore, do not require adjustment; however, we may make adjustments (either increases or decreases) to these cooperatives' cost of goods sold where we believe there is a material difference between the assigned values and market value.
- 6 Other cooperatives have difficulty in determining the market prices of patrons' products when they receive them because of limited cash purchases by other processors and therefore limited market price data. They are usually cooperatives that process and market a high percentage of limited specialty crops. Because amounts that approximate estimated market value are not assigned to products received from patrons, cost of goods sold does not include a charge for the value of the input (i.e., earnings are imputed relative to other cooperatives and companies that recognize a cost related to the input). In these cases, we estimate the input cost of the sold inventory based on market prices or the cost to produce the inventory, and add that estimate to cost of sales (i.e., thereby reducing EBITDA, EBIT, and EBT). In such cases, we would consider any remaining difference between the cooperative's reported member distributions and our cost of sales estimate as a dividend distribution.
- 7 Lastly, under U.S. GAAP, cooperatives may account for the inventory at net realizable value (as opposed to the lower of cost or market prices, which we prefer). Under this method, a cooperative values its inventory at estimated selling prices less reasonably predictable costs of competition, disposal, and transportation. Changes in the net realizable value of the inventory are recorded in cost of goods sold. We make analytical adjustments to cost of goods sold to reverse these gains or losses as they relate to unsold inventory.

<sup>8</sup> Data requirements:

An estimate of the input cost of the delivered inventory, primarily by either estimating the unit cost from other comparable sales transactions of the commodity and multiplying by the number of units sold, or by estimating the cost to produce the commodity.

The amount of net realized value adjustments reported in cost of sales in the period

<sup>9</sup> Calculations:

To determine cost of sales:

For cooperatives where the assigned value of sold inventory is deemed to be materially different than market value, we add to or subtract from cost of sales the difference between market value and the assigned value.

For cooperatives that do not assign a value to inputs received from patrons, we add the estimated cost of the commodity inventory to cost of sales.

For cooperatives that measure the inventory using the net realized value method, we remove from cost of sales the net realized value gains or losses recorded in the period.

To determine the value of dividends:

For cooperatives that do not assign a value to inputs received from patrons and report member dividend payments separately as an operating cash outflow (excluding any additional retained member equity and dividends already reported as financing cash inflows/outflows), we subtract from member dividends reported as operating cash outflows the difference between the reported member dividends and our cost of sales estimate, and add that difference to dividends (i.e., and thereby treat that as a financing cash outflow).

## Branded nondurables

- <sup>20</sup> **Excise taxes:** For companies operating in sectors where excise taxes are levied against consumers and collected by the company, including tobacco and alcoholic beverages, we deduct such excise taxes from both revenues and the cost of sales of the company includes them in the reported revenues figure, as we do not consider those tax items as operating revenues or costs.

## Captive finance operations

<sup>2</sup> Data requirements:

Reported captive finance unsecured assets. We determine captive finance assets as the sum of on and off-balance sheet (e.g. securitizations) lease receivables, leased assets (when the captive finance unit acts as operating lessor), loans given to customers, and any other earning assets.

Reported captive finance unsecured debt. We use debt as defined in our "Ratios And Adjustments" criteria. For example, we adjust reported debt to reflect the debt equivalent of securitized assets and hybrid securitizations. Intercompany debt on the captive's books is generally included in our definition of captive debt as long as the parent has originated the intercompany debt from third parties. In cases where the parent has no reported debt and it ends to its captive, we would exclude the intercompany loan from the captive's debt. We cap the captive's debt at the adjusted consolidated debt level. Similar adjustment may be warranted for intercompany debt if the captive ends to the parent.

Reported captive finance unsecured equity. We use the captive finance company's equity including

any minority interest if the captive is not fully owned.

Reported captive finance unit revenue.

Reported captive finance unit EBIT or EBITDA.

Reported captive finance unit operating expenses.

Reported captive finance unit depreciation and amortization (D&A) and non-current asset impairments.

Reported captive finance unit interest expense.

Reported captive finance unit current tax expense.

Reported captive finance unit interest paid.

Reported captive finance unit cash tax paid.

Reported captive finance unit interest income.

Reported captive finance unit cash flows from operations.

Reported captive finance unit capital expenditure.

Reported captive finance unit cash, cash equivalents, and liquid investments.

<sup>22</sup> Calculations:

Captive finance unit debt: We use the reported captive finance unit debt as defined above. If the reported figures are not available, we estimate the captive debt and equity based on the captive assets and an appropriate debt-to-equity ratio. We determine the appropriate debt-to-equity ratio using table 6 of "The Impact of Captive Finance Operations on Nonfinancial Corporate Issuers" criteria. First, we select the average range for an intermediate/significant asset and average risk corresponding to the captive's financial portfolio quality assessment. Then, we generally select the midpoint of that average range as the debt-to-equity ratio unless we believe that the high or low end of the range is more appropriate, based on the relative strength or weakness of the portfolio quality within the assessment category. This may be informed by the severity of historical losses, and positive or negative underwriting standards considerations. Next, we cap the captive finance unit's estimated debt resulting from the above calculation at the adjusted consolidated debt level of the combined enterprise.

Captive finance equity: If the reported figures are not available, we calculate the captive finance unit's equity by deducting the captive finance unit debt, as determined above, from total captive finance unit assets.

Captive finance unit revenues: If the reported figures are not available, we estimate the captive finance unit revenues by multiplying the average captive finance unit asset value (mathematical average of opening and closing assets as discussed above) by an appropriate revenue factor. We use 5% as the revenue factor, unless we have reasons to believe, based on our discussions with the company, that a different revenue factor would be more appropriate.

Captive finance unit EBITDA: We calculate captive finance unit EBITDA as captive finance revenue less captive finance operating expenses, plus captive finance D&A and non-current asset impairment. If reported figures are not available, we calculate the individual elements as discussed below. We do not take into account any dividend flow between the captive finance unit and its parent company in calculating the parent's adjusted financial metrics.

Captive finance unit operating expenses: We estimate these by multiplying the average captive finance unit asset value (mathematical average of the opening and closing asset as determined

above) by an appropriate operating expense factor. The captive finance unit's D&A and impairment may be material when the captive finance unit acts as operating lessor and therefore holds material nonfinancial assets on its balance sheet. In those cases, we estimate D&A by multiplying the average captive finance unit nonfinancial asset value (mathematical average of opening and closing asset) by an appropriate depreciation and amortization rate that represents the average useful lives of the leased assets. We do not estimate impairment charges.

Captive finance unit interest expense: If the reported figure is not available, we calculate the captive finance unit's interest expense by applying an appropriate interest rate on the mathematical average of the previous and current year-end captive finance unit's debt. We use a long term (such as a 10 year) government bond interest rate, unless we have reasons to believe, based on our discussions with the company, that a different interest rate is more appropriate.

Captive interest paid: If the reported figure is not available, we would take the captive finance unit's interest expense as determined above.

Captive finance unit cash tax paid: If the reported figure is not available, we calculate the captive finance unit's cash tax paid by applying an appropriate tax rate to the theoretical captive finance unit profit before taxes. The tax rate reflects the rate applicable for the captive finance unit. This tax rate may not be the same as the parent's tax rate if the captive finance unit is in a different tax jurisdiction.

Captive finance net loss ratio: We calculate the net loss ratio as gross losses minus recoveries divided by average net earning assets outstanding. For operating lease assets, we include in the net loss ratio both credited losses on outstanding receivables and losses on residual value whenever possible. We include a managed assets in our analysis, adding back the off-balance sheet assets to determine net earning assets.

Access to cash. When sufficient evidence is available that the captive's cash, cash equivalents, and liquid investments are accessible to the parent and available for debt repayment, we include them in our calculation of access to cash.

## Commodities trading

<sup>23</sup> In deriving and interpreting a commodities trader's financial measures, it is critical to consider the accounting valuation method for trading assets and liabilities (including both physical positions and derivatives) and the approach to recognizing gains and losses in the income statement. In our experience, virtually all commodities traders report under IFRS or U.S. GAAP and therefore market to market a dominant share of trading related assets and liabilities, and traders recognize the related gains and losses realized and unrealized in earnings on an ongoing basis. We determine a commodities trader's EBT, EBTDA, and gross margin by including both realized and unrealized trading gains and losses. For a commodities trader, unrealized gains and losses, although non-cash, are an important component of core earnings, and including them in profitability measures provides a more accurate gauge of ongoing financial performance because derivatives gains or losses on the physical position tend to be offset by losses or gains on the corresponding derivative transaction.

<sup>24</sup> When adjusting a commodities trading company's credit measures for leases and related service contracts, we include commitments related to vessel chartering, storage facilities, and other fixed assets.

<sup>25</sup> We do not net access to cash for commodities traders with weak business positions or less

supportive trading risk management and trading risk positions.

<sup>26</sup> **ARM:** To reflect the highly liquid nature of certain physical commodities trading inventory, we make an additional adjustment for commodities traders in that we deduct ARM to determine debt and related financial measures (except when calculating the debt to debt plus equity supplementary ratio). Such netting is made against total debt, not just short term debt, for a commodities trader (including those with a weak business position or less supportive trading risk management and trading risk position). See the description of core and supplementary ratios in our "Commodities Trading Industry Methodology."

<sup>27</sup> We include in ARM the portion of inventory that meets all of the following conditions:

The inventory is either hedged or "pre-sold";

The inventory could realistically be liquidated within 30 days (whatever the ultimate terms of the trading position), and the related hedges could be unwound (we net from the value of the gross trading asset any cash needed to terminate the related hedges);

The inventory liquidation would not harm the business franchise of the commodities trader—for example, where the company serves as the "market maker" for the commodity in question;

The inventory is not held for processing by the company; rather, we include only inventory that we believe will be used only for trading purposes; and

The proceeds of any inventory liquidation would be accessible for debt repayment, i.e., not trapped in a foreign subsidiary, unless local debt could be serviced.

<sup>28</sup> In addition, to account for losses that could result from a rapid liquidation, we apply a haircut to reported inventory values according to our view of the relevant commodity market's volatility. We base the haircut on the commodity risk assessments in table 3 of our commodities trading industry methodology. For category 1 commodities the haircut is 0%, and for category 2 the haircut is 25%.

<sup>29</sup> To apply this adjustment, we use a broad breakdown of trading inventory by commodity, generalized information about how much the commodity is hedged or pre-sold, and the duration of related trades.

## Financial market infrastructures

<sup>30</sup> **Treatment of CPP and CSD balances:** Within the financial market infrastructures (MI) sector, international central securities depositories (CSDs) typically have large varying amounts of deposits that appear on the balance sheets but are dedicated to central settlement activity and are invested in highly liquid, highly creditworthy instruments rather than being available to support the corporate activity of the CSD. Similarly, clearinghouse balance sheets substantially consist of central related assets and liabilities, such as net margins and the replacement value of some types of unsettled trades.

<sup>31</sup> For CSDs, clearinghouses, and groups that have clearinghouses or CSDs, we typically do not include clearing or settlement assets or obligations, nor central deposits and related investments (for CSDs) in our balance sheet measures (for example, in adjusted debt and adjusted assets). "Clearing obligations" typically refer to clearing liabilities that are usually non-debt and may include net a/cor variation margin postings. "Settlement obligations" typically refer to member deposits lodged at CSDs. Similarly, we tend to exclude the movement in these assets and liabilities from our cash flow analyses.

<sup>32</sup> **Accessible cash and liquid investments:** Our approach to access b e cash and liquid investments reflects that M s tend to be more highly regulated than other corporate sectors, with subsidiaries often subject to regulatory prudent requirements. For example, we treat as trapped cash in regulated subsidiaries that supports minimum capital or other loss absorbency requirements. Where we see cash balances as volatile, we make a prudent assumption of the level of accessible cash that can be relied on. For example, where cash balances are seasonal, we adjust accessible cash if we see period-end reported balances as unrepresentative. Volatility may also arise, for example, from M s exposed to potential losses on unsecured exposures.

## Forest and paper products

<sup>33</sup> **Valuation of timberlands:** Under certain accounting frameworks (such as IRS) timberlands are carried at fair value and therefore equity reflects the appreciated value of these assets. However, under other accounting regimes (such as U.S. GAAP) timberlands are carried at historical cost. The market value of timberlands often substantially greater than book value, and we believe that book value based ratios could materially overstate a timberland company's leverage. To gain comparability between companies that mark the timberlands to market compared with those that carry them at cost, we make adjustments to the equity of those that carry them at cost to evaluate leverage and return on capital.

<sup>34</sup> We do not, however, make a corresponding mark to market adjustment to EBIT for return on capital. Likewise, any mark to market adjustments recorded in the reported results of IRS reporters are excluded from our measure of EBIT.

<sup>35</sup> We estimate the market value of timberlands on a company specific basis because values vary by region and incorporate third party appraisals and recent timberland transactions into our estimates when available.

<sup>36</sup> Calculations:

Equity: We add to equity the difference between the estimated market value of timberlands and the corresponding book value.

## Homebuilders and real estate developers

<sup>37</sup> **Land procurement approaches:** We don't adjust debt to reflect land options and purchase commitments even when we view them as inflexible or highly likely to be exercised and honored. This is because, in our financial forecasts which partly serve as the basis of our assessment of cash flow/leverage and liquidity we factor in our expectations regarding the cost of land purchases and the related expected financing mix.

<sup>38</sup> **Impairment charges:** Inventory (consisting of houses or buildings under construction, completed houses or buildings that have not been sold, and under development, and land held for future development) is typically valued at the lower of cost or market price. In industry downturns, valuing the inventory at market price can lead to large inventory write down charges in the income statement. Given the unevenness of these charges, we generally add back these charges to our profitability and cash flow proxy measures.

<sup>39</sup> Data requirements:



Write down charges related to inventory in the period considered to be nonrecurring.

40 Calculations:

EB TDA, EB T, and O: Add the inventory write down charges that are considered to be nonrecurring.

41 **Revaluation gains and losses:** Where companies mark the r properties to market on an ongoing basis (as under RS), we generally exclude the resulting unrealized revaluation gains and losses from our profitability and cash flow proxy measures. We believe that these unrealized gains and losses, while stemming from operating activities, can distort the company's financial performance metrics. Nonetheless, we do account for the market factors that cause revaluation gains and losses, for example, in determining our forecast assumptions because these can be important indicators of market trends.

42 Data requirements:

Revaluation gains and losses related to inventory in the period.

43 Calculations:

EB TDA, EB T, and O: Subtract or add revaluations gains and losses.

44 **Capitalized interest:** Homebuilders and developers may capitalize a significant amount of the r cash interest costs to inventory (including property construction in progress) because land acquisition and construction costs are typically capitalized until buildings are built on the lots. The recognition of interest costs in the income statement is therefore deferred until the related inventory is sold. For analytical purposes, similar to our treatment of interest capitalized as part of property, plant, and equipment, we seek to recognize interest costs as an expense in the period when incurred rather than when the inventory is sold and make adjustments to reverse the accounting. In terms of analyzing cash flows, we include a cash paid for interest as an operating cash flow.

45 Data requirements:

The amount of interest costs capitalized as part of inventory in the period.

The amount of interest costs previously capitalized as part of inventory that was recognized as part of cost of goods sold in the period.

Cash paid for interest costs that is capitalized as part of inventory reported as either investing activities or financing activities.

46 Calculations:

Interest cost capitalized is subtracted from the cost of goods sold.

EB TDA and EB T: Add to EB TDA and EB T the amount of interest that was previously capitalized that was released to cost of goods sold in the period.

Interest expense: Add to interest expense the amount of interest capitalized in the period.

C O: Subtract from C O any interest reported as either investing or financing.

- 47 **Unconsolidated affiliates:** It is common for developers and sometimes homebuilders to conduct a large portion of their business through partially owned subsidiaries or joint ventures, thereby sharing risks and investments with other owners. These entities are often organized around individual properties or groups of properties and have their own external debt financing. Under current IFRS and U.S. accounting standards, these affiliates are generally accounted for using the equity method if the company's ownership interest is less than 50%. We may reflect contribution from unconsolidated affiliates by adding dividend payments received from those affiliates to EBITDA.
- 48 Generally, we utilize pro rata consolidation where we view the leverage of equity method affiliates as material. In some cases, equity method accounting can understate the true extent of financial leverage being employed within the broader group from an analytical perspective. In such cases, pro rata consolidation more meaningfully depicts the economic reality, and so often we adjust the financial statements to reflect pro rata debt, earnings, and interest expense, if available. Alternatively, if a company's unique ability to support the debt of an affiliated entity, the analyst might not include the debt in question in the leverage ratios. At the other extreme, if a company's high ability to support the affiliates obligations our analyst might fully consolidate the affiliate for analytical purposes.

## Media and entertainment

- 49 **Program development and acquisition costs:** Across multiple media subsectors, program development and acquisition costs (e.g., film producers programming and film expenditures, educational publishers program development costs, and local TV broadcasters program rights) are capitalized and amortized to income using various systematic approaches. However, we view these items as operating and we treat this amortization as a cost of sales (i.e., an operating cost) and therefore include the amortization (and any related write-downs) in EBITDA and CO.
- 50 Consistent with this characterization, we also view the cash paid for these assets to be operating. However, companies classify the cash outflow in the statement of cash flows in a variety of ways. We reclassify any cash outflows related to these capitalized costs reported as investing cash flows and do not include them in our definition of capital expenditures.
- 51 Data requirements:
- Amount of programming development and acquisition costs incurred and capitalized during the period that are classified as investing cash flows.
  - Amount of related amortization expense.
- 52 Calculations:
- Subtract from EBITDA and CO the relevant amortization expense for the period if it is not already reported as an operating expense.
  - Subtract from CO any capitalized program development and acquisition costs classified as an investing cash outflow.
  - Subtract from capital expenditures any capitalized program development and acquisition costs reported as capital expenditures.

## Metals and mining upstream industry

- 53 **Streaming transactions:** A streaming transaction is a feature of the mining industry and is an agreement whereby a commodity producer – for example, a base metal miner that also yields some precious metal byproduct through its mining – sells the right to a share of its future byproduct production at a preset price in exchange for an upfront payment, which becomes a liability of the commodity producer. The upfront payment is recognized as a trade liability because it is related to a future sale, and it often ranks par passu with other unsecured debt of the operating mine (in some cases, the liability may also benefit from guarantees). The use of funds is sometimes restricted to funding the construction or expansion of the mine from which the byproduct will be delivered, and in some instances the agreement may be subject to competition tests.
- 54 Such agreements are typically long dated – in some cases, covering the life of production – and the buyer has the rights to a portion of the output until the agreement term matures. The transaction provides the commodity producer with upfront financing and repayment flexibility because there are no fixed volume delivery obligations. The streaming agreement also typically allows the commodity producer to retain ownership and control of the producing unit, and secured interests are limited to the agreed-upon share of byproduct reserves and production.
- 55 We view these transactions as a form of financing, and, therefore, we adjust our debt and related credit measures if the transactions have some combination of the following features:
- if they are done in lieu of borrowing;
  - if they are repayable in cash if they are not satisfied by the product's delivery;
  - if the counterparty has recourse to the issuer or a guarantor in the case of insolvency;
  - if repayment can be accelerated upon an event of default; or
  - if there is high overcollateralization or security to production coverage or some other mechanism that provides greater certainty of repayment.
- 56 We nevertheless recognize the lower default risk of streaming transactions, given the absence of fixed volume delivery obligations, as well as significant financial flexibility the transactions can provide to low-rated or start-up mining companies.
- 57 For financial reporting purposes, issuers generally determine the amortization of the obligation that is recognized as revenue for each period using a units-of-production method. At inception, the company determines a per-unit amortization amount based on the upfront prepayment amount divided by the total units it expects to deliver to the counterparty over the life of the contract. The price per unit delivered varies over time based on changes in the ultimate expected output. As such, revenue, EBITDA, and EBIT include the non-cash amortization, whereas COGS does not.
- 58 These contracts usually do not contain a stated interest rate, and we have found that accounting practices differ among companies, whereby some impute interest on these transactions in their financial statements, and others do not. Imputation of interest affects the amount of revenue and interest expense recognized. If an issuer is imputing interest on these transactions at a reasonable rate, we do not adjust the reported revenue, related EBITDA, and interest expense. We instead add the reported unamortized obligation to adjusted debt. For an issuer that does not impute interest, we maintain an amortization schedule and make additional adjustments as detailed below.
- 59 Data requirements:
- The original upfront payment amount.

The interest rate provided by the issuer or computed based on the expected term, volume, and price of debt. Alternatively, we may use an estimate of this rate based on the issuer's average cost of debt.

The amount of amortization during the period.

An estimate of the incremental amortization rate, if interest had been imputed based on the percentage difference between the total undiscounted value of the product expected to be delivered and the amount of the upfront payment received.

<sup>60</sup> Calculations:

Debt: We add the unamortized obligation as adjusted for imputed interest if needed.

EB TDA: We add the incremental revenue that would have been recognized if interest had been imputed at the imputed rate, calculated as the amortization during the period times the incremental amortization rate.

Interest expense: We add the interest imputed on the adjusted obligation on a compound basis.

CO: In the period when the upfront payments received, we subtract the upfront payment from cash flow from operations. No adjustments are made in subsequent periods.

## Oil and gas exploration and production (E&P)

<sup>6</sup> **Exploration costs:** Oil and gas E&P companies must choose between two accounting methods: full cost or successful efforts, which differ in terms of what investment outlays companies capitalize or expense. A full cost company capitalizes all costs of property acquisition, exploration, and development. A company using the successful efforts accounting approach only capitalizes property acquisition costs, drilling, and development costs from successful exploration. Companies using the successful efforts method report their exploration expenses separately in the income statement while full cost companies capitalize exploration costs and do not report exploration expense separately in the income statement.

<sup>62</sup> To gain comparability within the sector, we adjust EB TDA to exclude all exploration costs. This adjusted measure conforms to the industry standard known as EB TDAX. With this adjustment, we calculate an EB TDA related ratio using our equivalent of EB TDAX. Although we add back the exploration expense companies report using successful efforts accounting to derive EB TDA, we reverse this adjustment when calculating CO; in other words, we reduce CO by the amount of exploration costs. We take this alternative approach to have some degree of comparability with other industries. Likewise, companies often report cash paid for exploration in the statement of cash flows differently. We generally do not attempt to make adjustments to these amounts in the statement of cash flows, but rather rely more heavily on CO to debt as a supplemental measure of cash flow to leverage because the classification of these amounts doesn't affect this.

<sup>63</sup> Data requirements:

Exploration expense in the period as reported by companies following the successful efforts approach.

<sup>64</sup> Calculations:

EB TDA: We add back to the reported EB TDA the exploration expense of companies that follow the successful efforts approach.

O: We include the exporator cost in the calculation of O.

65 **Economic hedging:** E&P companies often manage the exposure to fluctuations in commodity prices and foreign currencies through hedges. When derivatives are not designated as hedges as provided for under accounting standards or do not qualify for hedge accounting, derivative gains and losses flow through the income statement each period. Realized gains and losses relate to transactions in the current period, and unrealized gains and losses to future transactions. When the derivatives do not qualify for hedge accounting or are not designated as hedges, we typically estimate from EBITDA unrealized gains and losses relating to future production, where we can identify these effects, focusing on earnings that only include realized hedge effects.

66 **Volumetric production payments:** A volumetric production payment (VPP) is an arrangement in which an E&P company agrees to deliver a specified quantity of hydrocarbons from specific properties (or fields) to a counterparty in return for a fixed amount of cash received at the beginning of the transaction. The seller often bears a portion of the production and development costs associated with delivering the agreed upon volumes. The buyer receives a non-operating interest in the oil and gas properties that produce the required volumes. The security is a real interest in the producing properties that the parties expect to survive any bankruptcy of the E&P company that sold the VPP. After the total required volumes are delivered, the production payment arrangement terminates and the conveyed interest reverts back to the seller.

67 We view VPPs structured with a high level of investor protection (in terms of production coverage) as debt-like obligations rather than asset sales given the risks the E&P companies retain. In typical deals, there is substantial overcollateralization, with total field reserves significantly exceeding the volumes the seller promises under the VPP contract. The seller must deliver the agreed upon volumes and incur all associated operating and capital costs. If the seller does not meet the obligation, total risk-adjusted reserves in the field.

68 We would view a VPP structured with minimal overcollateralization to be closer to an asset sale because the transfer of risk would be more substantial. However, even in this case the VPP has some debt-like qualities because the company must pay the operating expenses associated with the VPP until delivery of the final volumes.

69 To make the adjustment to debt, we use a fair market value approach and the New York Mercantile Exchange (NYMEX) futures curve to calculate the expected value of the barrels to be delivered, which we consider to be debt. If hydrocarbon prices increase, so would the debt adjustment.

70 Data requirements:

Schedule of oil and natural gas volumes yet to be delivered under the VPP;

Oil and natural gas volumes produced during the year from the VPPs;

NYMEX futures curve for oil and natural gas prices as of period end; and

Price differential (for quality differences and geographic location) for the VPP volumes relative to NYMEX.

71 Calculations:

Debt: We multiply the oil and natural gas volumes to be delivered in each year of the contract by the futures price (adjusted for quality and location differentials) in that year. We then calculate the value of this revenue stream using a discount rate commensurate with the company's secured borrowing rate.

Interest expense: We impute interest expense on the adjustment to debt using the company's secured borrowing rate. We apply the rate to the average of the calculated VPP obligation at current and previous period end.

Debt to reserves: We add the hydrocarbon volumes the seeder hasn't yet delivered under the VPP back to reported reserves.

Seeding and lifting costs: We add the oil and gas volumes produced to meet the VPP requirements in calculating per unit seeding prices and lifting costs.

C O and O: We subtract the VPP cash proceeds from C O and O.

## Oil refining and marketing industry

72 Inventory gains: When a company using the last-in, first-out (LIFO) method has inventory balances that decrease over a period of time, LIFO inventory gains may result. This means that order layers of inventory are turned into cost of goods sold as a result ("order" refers to inventory in terms of accounting and not necessarily in a physical sense). Assuming an inflationary environment, the cost of goods sold is reduced and, as a result, income increases because of LIFO inventory gains. To capture the true sustainable profitability of a company, we generally exclude the gains generated from LIFO inventory gains from our profitability measures.

73 Data requirements:

LIFO inventory gains from the income statement.

74 Calculations:

EB TDA, EB T and O: Deduct LIFO inventory gains from EB TDA, EB T and O.

## Oilfield services and equipment industry

75 **Seismic accounting:** When seismic companies capture seismic data that they expect to sell to multiple clients, they capitalize the associated costs and amortize these costs over the expected useful lives of the data. However, we adjust these companies' financial results effectively recognizing these expenditures as an operating expense as incurred.

76 Data requirements:

Capitalize expenditures for multiple client data acquisition for the period.

Amortization of multiple client data acquisition costs for the period.

77 Calculations:

EB TDA, O, and C O: Deduct capitalize expenditures for multiple client data acquisition from EB TDA, O, and C O.

Capitalize spending: Deduct capitalize expenditures for multiple client data acquisition from total capitalize spending.

EB T: Deduct/add the difference between capitalize expenditures and amortization expense for multiple client data acquisition costs.

## Operating leasing

- <sup>78</sup> Operating lease companies may provide finance leases as well as operating leases to their customers. Payments customers make under the finance leases are accounted for as interest income (part of revenues) or repayment of principal (recorded as a financing cash flow). Since a portion of the payments, both interest and principal, are sources of cash flow to service debt, we add the repayment of principal to EBITDA, reclassifying those payments as an operating cash flow.
- <sup>79</sup> Operating lease companies often see equipment as part of a normal pattern of acquiring, leasing out, and disposing of their assets. Gains and losses realized on such equipment sales are part of the normal turnover of leased assets, we include such gains and losses as an adjustment to depreciation and an operating expense.

## Real estate (REITs)

- <sup>80</sup> **Straight-line rent:** The accounting treatment of rent payments received under real estate leases averages them out over the life of the lease. Consequently, reported rent revenue may differ from actual cash rent received where the minimum rent payment varies over the life of the lease. This can happen when there are periodic contractual rent increases or when the lease provides for an initial period with no rent or with discounted rent, followed by which normal periodic cash rent payments are required. Depending on the lease terms and life cycle, cash rent received may be higher or lower than reported rental income. For real estate companies, we will reverse, when material, the straight-line rent smoothing calculation of EBITDA. This is consistent with industry standards and with our focus in this sector on the amount of cash rent actually received by the company during the period. We adjust revenues, EBIT, EBITDA, and EBITD, by the amount that straight-line rental revenue reported exceeds or falls below cash rents received for the respective period.
- <sup>81</sup> **Unconsolidated affiliates:** It is common for real estate companies to conduct a large portion of their business through partially owned subsidiaries or joint ventures, thereby sharing risks with other owners. These entities are often organized around individual properties or groups of properties and have their own external debt financing. Under accounting standards, these affiliates are generally accounted for using the equity method if the company's ownership interest is 50% or less. From an analytical perspective, equity method accounting can understate the true extent of financial leverage within the broader group. As a result:

We may adjust the financial statements to exclude dividends received and reflect pro rata consolidation of debt, earnings, and interest expense. In our view, this better depicts the economic reality.

If we believe the company's highly likely to support all the affiliates' obligations, we may apply full consolidation.

Alternatively, if we believe a company's unlikely to support the debt of an affiliated affiliate, we might exclude that affiliate from our financial measures, even if it is fully consolidated for financial reporting purposes. Even though these debt obligations are typically nonrecourse property lease debt, we will only exclude the affiliated affiliate's debt from our financial measures if we believe the failure to support the affiliate will not limit the issuer's access to capital markets. Additionally, in order for us to exclude the debt of these affiliates, the debt should not have cross default, cross acceleration, or any similar influence on the debt issued by the real estate company. Examples of companies where we would do this include minority owned joint

ventures and properties included in commercial mortgage backed securitizations.

### Capitalized interest:

<sup>82</sup> Real estate companies engaged in sizable debt financed development projects may capitalize a significant amount of the interest costs, thereby deferring the recognition of interest expense on the income statement. In our analysis, we factor in capitalized interest as an expense in the period when incurred. The valuation of property, plant, and equipment includes, under U.S. GAAP, a cost of carry element relating to multi-period project expenditures. Part of the rationale is that the company must factor in the carrying costs when deciding on a project's economics, but this obscures the amount that actually must be paid during the period. Companies may also have significant discretion with respect to the amounts they capitalize, making comparisons difficult.

### Regulated utilities

<sup>83</sup> **Inflation linked debt:** Some companies in the regulated electric utility and water sectors issue significant amounts of inflation linked debt, notably in the U.K. where future regulated rate increases are linked to inflation indexes such as the retail price index (RPI). Inflation linked debt is also commonly issued across several sectors in Europe. Inflation linked debt usually has a long tenor (20-30 years), and a low annual cash coupon (e.g., 3%) that, without indexation, would usually represent a below market cost of debt at issuance for the issuer, as it only reflects real term interest rates.

<sup>84</sup> A distinct, typical feature of inflation linked debt is the deferral of indexation payments to maturity. We view the accrual of principal indexation as a part of a non-cash coupon. Deferral of payment does not mean that this debt is any cheaper; simply, a portion of its periodic cost, which may be substantial, is being deferred to maturity.

<sup>85</sup> We typically apply a charge for the indexation of principal for inflation linked debt in our calculations. We believe this approach better captures the after interest cash flow the company's operations generate, including the full cost of the debt used to finance those operations. Where companies have not disclosed the amount of principal indexation, we may estimate the adjustment.

<sup>86</sup> No adjustment is typically required to be made to reported debt if this includes the effect of the indexation component (the "deferred interest" portion) on a cumulative, compounded basis.

<sup>87</sup> Where possible we make similar adjustments where companies use derivatives to synthetically convert debt into inflation linked debt. This can require deducting from the inflation payable of an inflation linked swap and adding to debt the portion of the derivative's fair value that corresponds to the cumulative deferred interest.

<sup>88</sup> **Purchased power adjustment:** We may view long term purchased power agreements (PPA) as creating fixed, debt-like financial obligations that represent substitutes for debt financed capital investments in generation capacity. If the lease obligations include PPAs, we may reduce the lease obligations to reflect the burden of the contractual payments that ultimately rests with ratepayers, as when the utility merely acts as a conduit for the delivery of a third party's electricity, or where the regulator has established a separate adjustment mechanism for recovery of a prudent PPA costs. Conversely, if the lease obligations exclude PPAs because of the contract's terms, and we believe those contracts are very material, we may add to debt an appropriate percentage (using an analytical determination risk factor) of the present value (using a company specific discount rate)



of the stream of capacity payments associated with the PPAs.

<sup>89</sup> **Natural gas inventory adjustment:** In jurisdictions where a pass-through mechanism is used to recover purchased natural gas costs of gas distributed but not used within one year, we adjust for seasonal changes in short-term debt tied to building inventories of natural gas in non-peak periods for later use to meet peak loads in peak months. Such short-term debt is not considered to be part of the utility's permanent capital. Any history of non-trivial allowances of purchased gas costs would preclude the use of this adjustment. The accounting of natural gas inventories and associated short-term debt used to finance the purchases must be segregated from other trading activities.

<sup>90</sup> Data requirements:

Short-term debt amount associated with seasonal purchases of natural gas devoted to meeting peak load needs of captive utility customers.

<sup>9</sup> Calculations:

Adjustment to debt: we subtract the identified short-term debt from total debt.

<sup>92</sup> **Securitized debt adjustment:** For regulated utilities, we deconsolidate debt (and associated revenues and expenses) that the utility issues as part of a securitization of costs that have been segregated for specialized recovery by the government entity constituting authority authorized to mandate such recovery if the securitization structure contains a number of protective features:

An irrevocable, non-bypassable charge and an absolute transfer and first priority security interest in transit on property.

Periodic adjustments ("true up") of the charge to remediate over- or under-collectors compared with the debt service obligation. The true up ensures collectors match debt service over time and do not diverge significantly in the short run.

Reserve accounts to cover any temporary short-term shortfall in collectors.

<sup>93</sup> Utility cost recovery is in most instances mandated by statute. Examples of securitized costs include "stranded costs" (above-market utility costs that are deemed unrecoverable when a transition from regulation to competition occurs) and unusually large restoration costs following a major weather event such as a hurricane. If the defined features are present, the securitization effectively makes a consumer responsible for principal and interest payments, and the utility simply passes through an entity for servicing the debt. We therefore remove the debt and related revenues and expenses from our measures.

<sup>94</sup> Data requirements:

Amount of securitized debt on the utility's balance sheet at period end;

Interest expense related to securitized debt for the period; and

Principal payments on securitized debt during the period.

<sup>95</sup> Calculations:

Adjustment to debt: We subtract the securitized debt from total debt.

Adjustment to revenues: We reduce revenue allocated to securitized debt principal and interest. The adjustment is the sum of interest and principal payments made during the year.

Adjustment to operating income after D&A and EBIT: we reduce D&A related to the securitized

debt, which is assumed to equal the principal payments during the period. As a result, the reduction to operating income after D&A is only for the interest portion.

Adjustment to interest expense: We remove the interest expense of the secured debt from total interest expense.

Operating cash flows: We reduce operating cash flows for revenues and increase for the assumed interest amount related to the secured debt. This results in a net decrease to operating cash flows equal to the principal repayment amount.

## Retail and restaurants (auto retailers)

<sup>96</sup> **Auto retailers floor plan financing:** Despite the differing accounting characterizations of auto retailers floor plan financing arrangements (those with automakers captive finance arms and those with third party financiers), we consider auto retailers floor plan borrowings, regardless of source, more akin to trade payables than to debt. This is due to the borrowings being loan to value ratios (typically 100%), widespread availability, and long dated maturity, with repayment generally occurring once vehicles are sold, and because of a long history of manufacturer subsidies largely offsetting borrowing costs.

<sup>97</sup> We view floor plan borrowings as a part of working capital. When floor plan borrowings are included within reported debt, we move those liabilities to accounts payable. Likewise, we consider floor plan interest expense as an operating cost rather than a financing cost and add it to the cost of sales. We do not make any change in the treatment of floor plan interest expense, which is generally a readily included cost of sales. On the statement of cash flows, we include changes in a floor plan borrowings (both with captive and third parties) in the working capital section of cash flow from operations.

<sup>98</sup> Data requirements:

Amount of floor plan borrowings reported as debt.

Amount of floor plan interest expense reported by the company in interest expense for the period; and

floor plan borrowings/repayment reported by the company under financing activity in its statement of cash flows for the period.

<sup>99</sup> Calculations:

Debt: We subtract any floor plan borrowings reported as debt in the financial statements.

EBITDA and EBIT: We subtract floor plan interest expense from total interest expense and cash interest paid (included in reported cash interest) and treat it as a part of operating expense, thus reducing EBITDA by the floor plan interest.

CO: We reverse the impact of floor plan borrowings and repayments in the financing activity cash flow and treat it as a part of working capital (i.e., change in accounts payable), thus impacting cash flow from operations.

## Technology software and services

- 200 **Acquired deferred revenue:** Companies in this sector often have significant deferred revenue balances, given the pattern of cash received relative to when they provide services and what revenue recognition methods they employ. At any given time, the deferred revenue amount recorded on a company's balance sheet generally represents the cash received in advance, less the amount amortized to revenue for goods and services provided to date. This balance sheet amount differs from the fair value of this performance obligation, which must be recorded at the date of an acquisition. Because of how acquired deferred revenue is valued at the time of acquisition and its subsequent impact on revenue, it can distort the acquiring company's financial results, making them less representative of ongoing operations. We therefore make an adjustment to EBITDA and EBIT to mitigate this distortion by adding to EBITDA and EBIT the amortization in the period of the fair value adjustment to acquired deferred revenue.
- 201 **Software development costs:** For companies that operate with a business model that includes selling software to external parties, we aim to adjust for the capitalization of development costs for external use software if the information is available and the amounts material. Without clear reporting that delineates the software development costs into internal versus external use, we use analytical judgment to determine the appropriate amount of our adjustment.
- 202 We do not reverse the capitalization of software for internal use, consistent with our treatment of internal use software costs across all sectors. We do reverse the capitalization of software for external use and include it as an expense. In the income statement, this means reversing the amortization of previously capitalized costs and increasing research and development costs by the amount capitalized during the period. The net effect on adjusted EBITDA is a decrease by the amount capitalized during the period. The net effect on EBIT is a decrease (or increase) by the amount capitalized during the period minus the amount amortized during the period.

## Telecommunications and cable

- 203 **Subscriber acquisition costs:** Wireless telecommunications companies incur various costs to acquire new customers or subscribers, such as sales commissions and subsidies for wireless handsets, known as subscriber acquisition costs (SAC; also known as customer acquisition costs). While some wireless telecommunications companies expense SAC, others capitalize these costs, which makes comparing the reported financial performance difficult.
- 204 To enhance comparability, we adjust reported financial statements when a company capitalizes SAC and the relevant information is disclosed and the amounts are material. The adjustment aims to treat the capitalized SAC as if they had been expensed in the period incurred. The adjustment reduces EBITDA, EBIT, CO, and capital expenditures (if reported) by the amount of SAC capitalized during the year. Similarly, we will reduce the D&A expense for SAC amortization. Without sufficient disclosures, we would reduce the D&A by the amount capitalized so that the EBIT measures are not unduly suppressed.
- 205 Data requirements:
- Amount of SAC incurred and capitalized during the period; and
  - Amortization amount for SAC costs during the period.
- 206 Calculations:
- EBITDA, EBIT, CO, and capital expenditures: Subtract the amount of capitalized SAC;
  - EBIT: Subtract (or add) the difference between the amount of SAC capitalized and the SAC

amortization during the period; and

D&A: Subtract the amount of SAC amortized during the period.

207 **Adjustment to debt and EBITDA for master service agreements:** The International Accounting Standards Board's IFRS 6 will become effective for companies reporting under IFRS in 2019. The new rule will treat telecom tower master service agreements as an expense. We adjust for these contracts the same way that we adjust for operating leases to enhance comparability between mobile network operators that:

Own towers;

lease towers through a master lease agreement; or

Have signed a service agreement.

208 In our view, the current differences between the three models are not material enough to require different analytical treatment. The towers serve a similar purpose for network operators in all three cases, and are crucial to ongoing operations. Given that mobile operators need to either own these assets or ensure they have long-term access to them, we see a service agreement as similar to an operating lease.

209 Adjusting the mobile operator's figures to account for its service agreement has two material impacts:

Higher profitability because we exclude the fees paid to the tower company from operating expenses; as a result, EBITDA margins are higher.

Higher adjusted debt amount because we are adding the liability to the balance sheet. The impact on a mobile operator's credit metrics will generally depend on the length of the contract and the magnitude of the operator's debt.

210 Table 1 shows an example of how we would adjust the figures for an operator that makes annual payments of €40 under a 5-year contract with a tower company. Capitalizing the annual payment not only raises EBITDA but also debt, because we value the future obligation at a 7% discount. The net effect in this example is a average increase of 0.66x.

Table 1

**Example Of Adjustments Made For A Master Service Agreement**

	Revenues (€)	EBITDA	Margin (%)	Debt	Debt/EBITDA (x)
IFRS 6 reported figures	200	360	30	900	2.50
lease adjustment to EBITDA	0	40	3	0	(0.25)
lease adjustment to debt	0	0	0	364	0.9
S&P Global Ratings adjusted figures	200	400	33	264	3.6

211 The less indebted the company is, the higher the impact of a lease on its average ratio. The lease liability would be a larger component of total debt. However, there is little difference between a lease agreement and a service agreement in terms of cash flows and economic benefit to the mobile operator. We therefore aim to treat both contract types consistently when assessing the financial risk profile, which will maintain comparability between telecom companies' credit metrics.

212 Mobile network operators rely upon networks of radio towers, which support their business by

broadcasting signals to and receiving signals from the mobile devices of their customers. Traditionally, mobile operators have owned these assets. But over time, some operators have sold their towers to specialty infrastructure companies. They then rent space on the towers to place their antennas, which transmit and receive radio frequencies. This model typically employs a master lease agreement, whereby the mobile operator pays a fee in exchange for renting a specific space on the tower. The tower company also provides related maintenance. More recently, however, we've seen mobile operators sign long-term service agreements under which they have access to the full tower network but are not assigned specific spaces for their antennae. The tower company commits to manage deployment of the equipment to ensure an agreed level of service quality.

- 2.3 **IFRS treatment:** Under IFRS 6, leases will be recognized on the balance sheet and service contracts off balance sheet. Whether a contract is defined as a lease largely depends on the right to control an identified asset.
- 2.4 In a lease agreement, the mobile operator controls specific spaces on towers, which are used for their active equipment. This will be considered a lease contract because the asset is identified (designated space on specific towers) and the mobile operator remains in control of the identified asset. On its balance sheet, the mobile operator will recognize a right of use asset and lease liability based on discounted payments required under the lease. The mobile operator will not recognize the rental payments as an operating expense; instead, the asset will be depreciated and interest is recognized based on the outstanding lease liability.
- 2.5 However, in a service agreement, the tower operator controls the towers and can move the mobile operator's equipment to alternative towers if it chooses. Therefore the contract is to provide a service and does not contain a lease under IFRS 6. Contract fees will be treated as operating expenses and will remain off the balance sheet.
- 2.6 If we were to follow IFRS 6, adopting service accounting would immediately and materially strengthen a mobile operator's leverage ratios, compared with a leased tower scenario. But we do not believe the mobile operator's credit risk would have fundamentally changed, and think the more favorable financial comparison proposed under the new accounting standard would distort comparison across companies.
- 2.7 In deciding whether to adjust for service agreements, we sought to understand how a service arrangement substantively changes the operations and risk managed by mobile operators and tower companies alike. We think lease agreements already contain a service element because the tower company provides maintenance services in addition to the space on the towers. Service agreements could introduce new and materially value-added services, such as:
- Active management of the equipment on a tower company's network to meet key performance indicator service requirements; or
  - Implementation of new communication coverage requirements or protocols, for example, deployment of small cell stations and fifth generation (5G) mobile networks.
- 2.8 However, we do not view this as a certainty and anticipate scenarios where a service agreement tower portfolio remains a relevantly static, mature asset. As new technologies and coverage requirements emerge, mobile operators may choose to retain responsibility for active network management in order to differentiate themselves from peers and gain a competitive advantage. Therefore, although we see the potential for additional services under a service agreement, we currently do not see the difference as material enough to warrant a different treatment compared with many of our telecommunications issuers that have lease agreements in place. We would need to see clear evidence of this in practice before treating tower service agreements differently from lease agreements. This would likely require measurable signs of active network monitoring and

management, manifested in detailed real time analysis and active physical evolution, resulting in a more dynamic, less static network over time.

- 219 To facilitate global comparisons and benchmarking, our rating analysis incorporates quantitative adjustments to the reported financial statements of companies. These adjustments align a company's reported figures more closely with our view of underlying economic conditions and the credit risk inherent in its transactions and arrangements. Although we may adjust certain figures reported under applicable accounting principles, this does not imply that we change the company's application of those principles, the adequacy of its audit or financial reporting process, or the appropriateness of the accounting judgments made to fairly depict the company's financial position and performance for other purposes.
- 220 Our adjusted debt principle underpins our approach and drives many of the analytical adjustments we make. It results from our view that certain imputed financial arrangements are similar to debt. Depicting these transactions as debt often contrasts to how a company reports them - affects not only the quantitative depiction of debt, but also the measures of earnings and cash flows we use in our analyses.
- 221 In general, items that we add to reported debt include on and off balance sheet commitments to purchase or use of long life assets (such as lease obligations) or businesses (such as deferred purchase consideration) where the company accrues benefits of ownership. We typically view sale and leaseback transactions as a form of financing. If we can, we capitalize the entire sale amount to debt, even if the NPV of future lease payments is a lower figure.
- 222 Under IFRS, a mobile operator sells its towers to a tower company and then enters into a service agreement with that company, it has not entered into a sale and leaseback transaction because the service agreement does not meet the definition of a lease under IFRS 6. IFRS considers that the tower operator controls the network because it has "substantive substitution rights" to the asset.
- 223 By contrast, we do not believe this feature alone is sufficient to completely override our view that the transaction has an imputed financial component. This sort of transaction changes the mobile operator's situation. Pre-transaction, it owned and used the network of radio towers to generate cash flows. Post-transaction, it still makes use of the network of radio towers to generate cash flows, but it receives cash upfront in exchange for regular, fixed, and non-cancelable deferred payments (like a lease). In our view, the transaction does not clearly improve the fundamental financial risk profile, but the IFRS expense accounting treatment implies such an improvement by reducing its leverage. The same would be true if a mobile operator switched from a lease agreement to a service agreement or signed a service agreement with no prior access to the towers in lieu of buying or leasing them.
- 224 This guidance specifically addresses the tower master service agreement contract and the telecom sector, based on the unique characteristics. There are instances of other transactions and arrangements that share some features of the tower master service agreement, but where we don't make a debt adjustment. For example, some utilities spun off their transmission networks and then entered into service contracts for the transportation/transmission of gas and electricity. However, these utilities do not pay the service providers under a bilateral contract in the same way that mobile operators pay tower companies. Instead, the utilities sell to retail customers and allocates a portion of the revenues to distribution, transmission, and suppliers, on a regulated basis.
- 225 If disclosures in the financial statements lack sufficient detail, we may face practical challenges in adjusting the debt of mobile operators that use tower service agreements. However, this is a familiar issue. We frequently estimate our analytical adjustments based on additional information provided by issuers. For example, we seek information from issuers regarding the amount of cash

and liquid investments that they cannot access at short notice to repay debt, and use this information to apply a haircut to our surplus cash figure.

226 We acknowledge that we have decided to adjust for tower service agreements based on the sample size and short track record of such agreements to date. In time, if tower companies build a track record of active network management under these agreements, such that the service portion of the contracts demonstrates an overriding feature, we could change our view. This could lead us to treat tower service agreements as a service and reflect them as an expense, either in whole or, if we have sufficient data regarding the service portion of the contract, in part.

## Transportation cyclical industry

227 **Purchase commitments to partner entities providing transportation services:** In some cases, companies may contract with other entities to provide transportation services using those other entities' own equipment. In cases where the payments under such contracts are largely fixed and represent mostly a substitute for owning or renting equipment, we will capitalize the entire amount of the committed payments. Examples include time charters of ships with fixed payments that are mostly for ownership and, to a lesser extent, crewing costs. Where the contracted payments mostly represent reimbursement for other expenses, which may vary, we seek to estimate the proportion of the payments that represent a rental or ownership equivalent, and capitalize that. Examples include some airline capacity purchase agreements with partner regional airlines. In those agreements, a major airline may sublease regional aircraft to the regional airline (the ownership costs for which are accounted for as ready captured in the major airline's financial statements). Alternatively, the regional airline may provide its own aircraft. If the major airline nonetheless includes those indirect regional aircraft ownership costs as part of its own lease commitments, our capitalizing leases covers this. Where the major airline does not include the indirect regional aircraft ownership costs in its own lease commitments, we seek to estimate the proportion of the capacity purchase agreement that represents ownership costs. Non-ownership costs, which can be substantial, include labor and fuel, the latter a pass-through cost that can vary significantly over time.

## Transportation infrastructure

228 **Service concession arrangements:** We make the following adjustments to the reported financials of transportation infrastructure companies operating under concessions:

These companies generally report revenues from works and improvements to concession assets under the current interpretation of IFRS for service concession arrangements (IFRIC 2). This does not affect reported EBITDA, operating profit, or cash, because a corresponding operating cost is reported. We exclude these items from reported revenues and the cost of goods sold.

In addition, when a transportation infrastructure company operating under a concession agreement receives fixed or guaranteed revenues according to IFRIC 2, the company generally does not report this as revenue on its income statement. When this income corresponds to a cash payment, we include it in revenues and EBITDA.

229 Data requirements:

The amount of revenues and costs from works and improvements to infrastructure assets that are grossed up in the income statement.

The amount of guaranteed income that is classified as interest income rather than revenues.

230 Calculation:

Revenues and cost of goods sold or operating expenses. We exclude the amount of revenues and costs from works and improvements to infrastructure assets that are grossed up in the income statement.

Revenues and EB TDA. We add the amount of guaranteed income classified as interest income rather than revenues.

- 231 **Inflation linked debt:** Some companies in the transportation infrastructure sector issue significant amounts of inflation linked debt. Inflation linked debt usually has a long tenor (20-30 years), and a low annual cash coupon (e.g., 3%) which, without indexation, would usually represent a below market cost of debt at issuance for the issuer, as it only reflects real term interest rates.
- 232 A distinct, typical feature of inflation linked debt is the deferral of indexation payments to maturity. We view the accrual of principal indexation as a partial non-cash coupon. Deferral of payment does not mean that this debt is any cheaper; simply, a portion of its periodic cost, which may be substantial, is being deferred to maturity.
- 233 We typically apply a charge for the indexation of principal for inflation linked debt in our calculation. We believe this approach better captures the after interest cash flow the company's operations generate, including the full cost of the debt used to finance those operations. Where companies have not disclosed the amount of principal indexation, we may estimate the adjustment.
- 234 No adjustment is typically required to be made to reported debt if this includes the effect of the indexation component (the deferred interest portion) on a cumulative, compounded basis.
- 235 Where possible we make similar adjustments where companies use derivatives to synthetically convert debt into inflation linked debt. This can require deducting from the inflation payable portion of an inflation linked swap and adding to debt the portion of the derivatives fair value that corresponds to the cumulative deferred interest.
- 236 **Provisions for future maintenance:** Under most concession arrangements, companies have contractual obligations to maintain the infrastructure to a pre-specified level of service and/or to restore the infrastructure to a particular condition before giving it back to the grantor. These obligations may take different forms ranging from routine repair costs to major lifecycle overhauls.
- 237 Routine repair costs are expensed as incurred in the income statement and classified as operating cash flows in the cash flow statement.
- 238 For longer term, major maintenance obligations that affect multiple years, the company recognizes a provision for the estimated NPV of future cash outflows under most accounting standards. Changes in the provision are reflected in the income statement (usually within reported operating income) systematically over the corresponding number of years. The cost recognition therefore significantly diverges from the related cash flows. When the maintenance obligation is fulfilled, the spending may be classified as either operating or investing cash flows in the cash flow statement.
- 239 To allow for globally consistent and comparable financial analyses, we view this long term maintenance spending as more akin to capital expenditures (investing cash flows) and the related costs as non-operating in nature. We do not view the year-end provision as debt like.



240 Data requirements:

long term maintenance related income statement charge or reversal during the year, which we treat as non-operating.

Amount of maintenance cash outflows during the year.

24 Calculations:

Add (or subtract) the long term maintenance related income statement charge (or reversal) from the respective metrics such as operating income, before and after depreciation and amortization.

Recalculate the amount of maintenance cash outflows to capital expenditures if reported as operating cash flows.

## RELATED CRITERIA AND RESEARCH

### Related Criteria

Corporate Methodology: Ratios And Adjustments, April, 2019

### Related Research

Criteria And Guidance: Understanding The Difference, Dec. 15, 2017

This report does not constitute a rating action

This is a guidance document for Criteria (Guidance Document). Guidance Documents are not Criteria as they do not establish a methodological framework for determining Credit Ratings. Guidance Documents provide guidance on various matters including articulating how we may apply specific aspects of Criteria describing variables or considerations related to Criteria that may change over time providing additional information on non-fundamental factors that our analysts may consider in the application of Criteria and/or providing additional guidance on the exercise of analyst judgment under Criteria.

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