Criteria | Corporates | General:

Corporate Methodology: Ratios And Adjustments

April 1, 2019

OVERVIEW AND SCOPE

1. S&P Global Ratings is publishing its methodology for making analytical adjustments to companies' reported financial data.

2. These criteria would apply to entities we rate globally using our corporate methodology, including traditional corporates as well as financial companies in scope of our "Key Credit Factors For Asset Managers," "Key Credit Factors For Financial Market Infrastructure Companies," and "Key Credit Factors For Financial Services Finance Companies." The criteria will also apply to companies we rate under our methodology for investment holding companies, commodities trading companies, the operating leasing industry, and mid-market evaluations. The criteria would not apply to project finance entities and corporate securitizations because of their unique characteristics. For the related guidance article, see "Guidance: Corporate Methodology: Ratios And Adjustments," published April 1, 2019.

IMPACT ON OUTSTANDING RATINGS

3. We are revising and updating our methodology to provide greater clarity and transparency. We have reorganized our analytical adjustments into four overarching principles and the adjustments associated with these principles. We also modified our adjustments for lease accounting changes. Based on our preliminary testing, we expect these updated criteria to result in negligible rating changes and none by more than one notch.

Key Publication Information

- Original publication date: April 1, 2019
- Effective date: Immediately.
- These criteria address the fundamentals set out in "Principles Of Credit Ratings," published on Feb. 16, 2011.

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METHODOLOGY

4. An entity's financial statements and data are core inputs to our cash flow/leverage and competitive position analysis. We may make adjustments to the reported financial statements to calculate adjusted credit ratios in order to:

- Better align an entity's reported financial data with our view of the underlying economics of specific transactions, as well as continuing operations. This may include adjustments for transformational events.
- Improve the global comparability of financial data between companies and across industries and geographies. For example, we may adjust reported financial figures when credit ratios are affected by different applicable accounting principles, measurements, and recognition or disclosure practices.
- Adjust the consolidation approach embedded in reported financials to best reflect our opinion of an entity's business, economic, and financial ties to other members of the group including subsidiaries, holding companies, and affiliates.

5. We organize our ratios and adjustments methodological framework around key adjustment principles applied in the calculation of adjusted debt, earnings, cash flow, and interest, and three categories of adjustments that are consistent with these principles. The categories are:

- "Routine" adjustments generally made to all entities, where applicable. Examples of these would be adjustments for leases and post-retirement obligations.
- "Situational" adjustments expected to be applied only in rare circumstances and only if we believe that they will significantly affect a company's credit metrics and are not factored elsewhere in our rating analysis. Examples of these adjustments include foreign currency hedges of debt principal and other exposures such as litigation.
- "Sector-specific" adjustments pertain only to particular sectors.

Key Terms

When we use the following terms in our methodology, we define them as described below. All elements considered in these definitions should be read in conjunction with our Adjustment Principles, and are computed including all applicable adjustments as described in the accompanying guidance.

Capital: Debt plus equity.

Capitalization: Capital less goodwill that exceeds 10% of total adjusted assets.

Cash interest paid: Cash interest paid is the reported amount in the statement of cash flows adjusted for capitalized interest, coupon payments on debt-like hybrid instruments, and any imputed lease-related cash interest for companies where lease payments are characterized as operating expenses.

Cash flow from operations (CFO): CFO is also referred to as operating cash flow. This measure takes reported cash flows from operating activities (as opposed to investing and financing activities), and includes all cash interest received and paid, dividends received, and cash tax paid in the period.

Cash tax paid: Income taxes paid on taxable profit, or income tax refunded.

Discretionary cash flow (DCF): Free operating cash flow (FOCF) minus cash dividends paid on common and preferred stock, less share buybacks.

Debt: Financial debt including bank borrowings, loans, and debt capital market instruments.

Dividends paid: Dividends to common and preferred shareholders and to minority shareholders of consolidated subsidiaries.

EBIT: Revenue minus operating expenses. We then include interest income, the company's share of equity earnings of associates and joint ventures, and other recurring, non-operating items.

EBITDA: Revenue minus operating expenses (excluding depreciation, amortization, and non-current asset impairment and impairment reversals). We include cash dividends received from investments accounted for under the equity method, and exclude the company's share of these investees' profits. We also exclude share-based compensation expense payable in shares.

Equity: Common equity, minority interests, and certain other forms of non-debt financing.

Funds from operations (FFO): EBITDA, minus cash interest paid minus cash tax paid.

Free operating cash flow (FOCF): CFO minus capital expenditures.

Interest: This is the reported interest expense, including non-cash interest on conventional debt instruments (such as payment-in-kind, zero-coupon, and inflation-linked debt), minus any interest income derived from assets structurally linked to a debt instrument.

Revenues: Total sales and other revenues from operating activities.

Key Ratios

The key credit ratios that we use in the cash flow/leverage and competitive position analysis under our corporate methodology include core ratios, supplementary ratios, and profitability ratios.

Core ratios:

- FFO to debt
- Debt to EBITDA

Supplementary ratios:

- CFO to debt
- FOCF to debt
- DCF to debt
- FFO plus cash interest paid to cash interest paid (FFO cash interest cover)
- EBITDA to interest

Profitability ratios:

- EBIT to revenues (EBIT margin)
- EBITDA to revenues (EBITDA margin)
- EBIT to average of the beginning-of-year and end-of-year capital (return on capital)

ADJUSTMENT PRINCIPLES

6. We apply four key principles in our adjustments to reported financial data:

- Adjusted debt principle
- Adjusted earnings principle
- Adjusted cash flow principle
- Adjusted interest principle

Adjusted Debt Principle

7. Many of the analytical adjustments we make reflect our view of certain implicit financing transactions as being debt-like. Our depiction of these transactions as akin to debt can be contrary to how a company reports them and affects not only our quantification of debt, but also the measures of earnings we use in our analysis.

8. Our objective, where practicable, is to use an amortized cost method to calculate debt, consistent with the amortized cost method under accounting standards like International Financial Reporting

Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP). This method reflects debt as the amount of the original proceeds, plus interest calculated using the effective interest rate, minus repayments of principal and interest. We include accumulated payment-in-kind interest in our adjusted debt measure.

9. In general, items that we add to reported debt to calculate adjusted debt include:

- Incurred liabilities that provide no future offsetting operating benefit (such as underfunded postretirement employee benefits and asset retirement obligations);
- 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 benefits of ownership are accruing to the company; and
- Amounts relating to certain instances when a company accelerates the monetization of assets in lieu of borrowing (such as through securitization, sale, or factoring of accounts receivable).

10. Many of these adjustments reflect probable future calls on cash, but not all future calls on cash are forms of debt. We do not consider a company's future commitments to purchase goods or services it has not received as akin to debt. This is because these are executory contracts, which means a counterparty must still perform an action and the benefits of ownership have yet to accrue to the company. On the contrary, certain non-executory contracts are seen as debt.

11. Not all incurred liabilities are added to reported debt. The adjusted debt figure excludes obligations, such as accounts payable and other accrued liabilities, because we regard them as trade credit. However, if a company defers payment beyond the term customary for its supply chain (which can occur with reverse factoring, for example), we may adjust debt.

12. Additionally, in certain cases our adjusted debt measure may exclude obligations a company reports as debt. This is, for example, because we consider those obligations as equity-like rather than debt, e.g. certain hybrid instruments and certain shareholder loans.

Adjusted Earnings Principle

13. We adjust reported earnings to capture our view of the results of a company's continuing business activities and its ability to generate recurring cash flow from its operations. Our three measures of adjusted earnings are EBITDA, EBIT, and FFO.

14. Our adjusted EBITDA metric aims to capture the results of a company's operating activities before interest, taxes, and depreciation and amortization. In other words, EBITDA excludes the impact on earnings of capital spending and other investing and financing activities. Generally, this means that any income statement activity, the cash effects of which have been (or will be) classified as being from operating activities (excluding interest and taxes), is included in our definition of EBITDA.

15. Our adjusted EBIT metric measures profit after depreciation and amortization costs (and thereby factors in capital intensity and capital spending), as well as operating and non-operating factors. Our measure of EBIT includes most income statement activity except for interest and taxes. This includes activity we view as non-operating (which is, however, excluded from EBITDA).

16. Our FFO metric indicates a company's ability to generate recurring cash flows from operations independent of changes in working capital. We derive our FFO metric from adjusted EBITDA and subtract cash interest and cash taxes.

Adjusted Cash Flow Principle

17. We typically only adjust reported cash flows to reclassify transactions between the different categories in the statement of cash flows in order to facilitate comparing operating cash flows. We do this because our analysis focuses on the actual cash flows a company derives from its different activities.

18. Accordingly, we do not carry through all our debt and earnings adjustments to our adjusted cash flow measures. For example, although we consider pension obligations as debt, we accept the reporting of pension cash contributions as operating cash flows rather than reclassifying them as financing outflows (i.e. a repayment of debt principal).

19. We primarily rely on three measures of adjusted cash flow: CFO, FOCF, and DCF.

Adjusted Interest Principle

20. We adjust interest to reflect the reported and imputed borrowing costs associated with our adjusted debt measure. Our adjusted interest expense is primarily used for supplementary coverage ratios. We generally do not net interest income from our adjusted interest expense unless it is generated by assets which we view as structurally linked to debt-like instruments, such as post-retirement obligations and asset retirement obligations.

ANALYTICAL ADJUSTMENTS

21. Our use of analytical adjustments typically depends on whether the transactions and items a company reports could materially affect our view of the company's credit metrics. Therefore, we may not make certain adjustments if we believe the related amounts are immaterial to our analysis. There are three categories of analytical adjustments: routine, situational, and sector-specific.

Routine Adjustments

22. We typically make the following routine adjustments to all companies, where applicable and material:

- Accessible cash and liquid investments
- Leases
- Postretirement employee benefits and deferred compensation
- Asset-retirement obligations
- Capitalized development costs
- Securitization, sale, and factoring of receivables and other assets
- Hybrid capital instruments
- Capitalized interest
- Financial guarantees
- Earn outs and deferred consideration for business acquisitions

Accessible cash and liquid investments

23. We calculate adjusted debt net of accessible cash and liquid investments (accessible cash), because a company that has cash available to repay debt on short notice has more financial flexibility than a company with no such cash available. In analyzing a company's cash and investments, we focus on their accessibility and liquidity. Our adjustment for accessible cash is company-specific; we calculate the amount based on information of a company's quickly accessible cash holdings and investment portfolio.

24. Accessible cash includes:

- All cash and cash equivalents as reported by the company, unless we have evidence that the cash might be inaccessible as described in the ratios and adjustments guidance document;
- Short-term investments as reported by the company, unless we have evidence they are illiquid or inaccessible; and
- Long-term investments and other assets in situations where we have evidence that they are liquid and accessible.

25. In situations where we determine that a company's weaker business characteristics or its ownership by financial sponsors do not support this adjustment, we do not net accessible cash against debt (please see our ratios and adjustments guidance document for more information).

Leases

26. Under lease arrangements, the lessee contracts for the use of an asset, entering into a debt-like financing obligation to make periodic rental payments. To account for this, we adjust debt, earnings, cash flows, and interest for comparability across accounting regimes. In certain cases, we may increase lease liabilities if we believe the reported lease disclosure does not adequately capture the lease leverage, for example if we view remaining lease terms to be artificially short relative to the expected use of the lease asset.

Postretirement employee benefits and deferred compensation

27. We include underfunded defined-benefit obligations for retirees, including pensions and health care coverage (collectively, postretirement benefits [PRB]) in our measure of adjusted debt. These obligations also include other forms of deferred compensation like retiree lump-sum payment schemes and long-service awards. We include these obligations in our measure of adjusted debt because they represent financial obligations that must be paid over time. We do not include defined-contribution obligations in our calculation of PRB.

28. We aggregate all retiree benefit plan assets and liabilities for pension, health, and other obligations, netting 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.

Asset-retirement obligations

29. Asset-retirement obligations (AROs) or decommissioning liabilities are legal obligations associated with a company's retirement of tangible long-term assets. In line with our adjusted debt principle, we treat AROs as debt-like obligations. We add AROs to debt after deducting any dedicated retirement-fund assets or provisions, salvage value, and anticipated tax benefits.

Capitalized development costs

30. In financial reporting, research costs are almost universally treated as an expense. However, the treatment of development costs varies because of the differences between accounting regimes and the subjectivity in determining when development costs are capitalized. To enhance comparability, we generally treat all capitalized development costs as if they were expensed in the period incurred.

Securitization, sale, and factoring of receivables and other assets

31. We regard the securitization, sale, and factoring of trade receivables and other assets generated on an ongoing basis in the ordinary course of business as being akin to secured financing. We make this adjustment even when the transaction is non-recourse because in our view moral obligation payments may occur, and we do not presume the company will have permanent access to the securitization or factoring market and may need to incur conventional debt to replace this source of financing.

32. We include the securitized debt-like obligations in our debt measures. For trade receivables sales or other asset sales, we include the trade receivable asset or other asset, respectively, on the balance sheet and add the associated funding liability to debt.

Hybrid capital instruments

33. The treatment of hybrid capital instruments in our leverage and debt service ratio calculations depends on the equity content classification of the instrument as determined by using our hybrid criteria.

Capitalized interest

34. Under most accounting regimes, financial statements capitalize interest costs during the construction of fixed assets. This can obscure the total interest that has been incurred during the construction period, hindering comparisons of the interest burden between companies that capitalize and do not capitalize interest. We include interest costs that have been capitalized in adjusted interest in the period when they were incurred.

Financial guarantees

35. A financial guarantee is a promise by one party to assume a liability of another party if that party fails to meet its obligations under the liability. If a company has guaranteed liabilities of a third party or an unconsolidated affiliate, we typically add the guaranteed amount to the company's reported debt. However, we do not add the guaranteed amount to debt if, in our opinion, the guaranteed party is sufficiently creditworthy. We typically add a lower amount to debt if we believe that, if the guarantee were called, the net amount payable would be lower than the guaranteed amount. We do not add performance guarantees to debt unless the company has a history of significant payments under these types of guarantees, or it is expected to incur such payments in the future.

Earn outs and deferred consideration for business acquisitions

36. Companies acquiring other companies sometimes finance a portion of the purchase price by entering into contingent consideration arrangements (that is, "earn outs") and/or by paying a fixed sum on a delayed basis (deferred consideration). We typically view these transactions as a form of financing and therefore we add the liability to debt to reflect this view.

Situational Adjustments

37. In rare circumstances, when our analysts believe a quantitative adjustment, such as the inclusion of an unusual liability in adjusted debt, is the most effective way to capture the risk inherent in an entity's particular circumstances, we will make a situational adjustment, even if not contemplated above.

38. Notwithstanding, if there is significant uncertainty about when an exposure may crystallize, or it is difficult to accurately quantify the impact, we may use alternative methods (such as the use of appropriate modifiers to derive the issuer credit rating) to capture these risks.

39. We may make situational adjustments for obligations and contingencies, including:

- Litigation and other contingent claims/liabilities;
- Workers' compensation and self-insurance liabilities;
- Multi-employer pension plans;
- Debt at fair value; and
- Foreign currency hedges of debt principal.

Sector-Specific Adjustments

40. We use our sector-specific adjustments to reflect the impact of unique industry characteristics on the adjusted financial metrics for a company. These sector-specific adjustments are consistent with our four adjustment principles and are made where applicable and material.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For Financial Market Infrastructure Companies, Dec. 9, 2014
- Key Credit Factors For Financial Services Finance Companies, Dec. 9, 2014
- Key Credit Factors For Asset Managers, Dec. 9, 2014
- The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29,

2014

- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Criteria Superseded

- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013

Criteria Partly Superseded

- Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Commodities Trading Industry Methodology, Jan. 19, 2017
- Key Credit Factors For The Operating Leasing Industry, Dec. 14, 2016
- Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- Key Credit Factors For Agricultural Cooperatives, March 17, 2015
- Key Credit Factors For The Agribusiness And Commodity Foods Industry, Jan. 29, 2015
- Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Key Credit Factors For The Oilfield Services And Equipment Industry, April 16, 2014
- Key Credit Factors For The Oil Refining And Marketing Industry, March 27, 2014
- Key Credit Factors For The Aerospace And Defense Industry, March 25, 2014
- Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- Key Credit Factors For The Media And Entertainment Industry, Dec. 24, 2013
- Key Credit Factors For The Metals And Mining Upstream Industry, Dec. 20, 2013
- Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- Corporate Methodology, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013

- Key Credit Factors For The Technology Software And Services Industry, Nov. 19, 2013
- Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Key Credit Factors For The Technology Hardware And Semiconductors Industry, Nov. 19, 2013
- Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013

Related Research

- Guidance: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria And Guidance: Understanding The Difference, Dec. 15, 2017

This report does not constitute a rating action.

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as S&P Global Ratings assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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