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S&P Global Ratings Requests Comments On Proposed Revisions To Its Methodology For Ratios And Adjustments

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NEW YORK (S&P Global Ratings) Jan. 3, 2019--S&P Global Ratings is requesting comments from interested market participants on proposed revisions to its methodology for making analytical adjustments to companies' reported financial data.

These revisions update our "Ratios And Adjustments" methodology to provide greater transparency. We have reorganized our framework into four overarching principles and their associated adjustments. We also modified our adjustments for lease accounting changes, which we expect will not significantly affect our ratings. Based on our testing, we expect these proposed updates to result in negligible rating changes and none by more than one notch.

Below are the key proposed changes to our existing methodology:

1. We propose to organize our analytical adjustments into three categories as follows:

- "Routine" adjustments, which are generally made to all entities, where applicable.
- "Situational" adjustments, which are expected to be applied only in rare circumstances and only if we believe that they will significantly impact a company's credit metrics and are not factored elsewhere in our rating analysis.
- "Sector-specific" adjustments, which pertain only to particular sectors.

Sector-specific analytical adjustments were previously part of our industry-focused Key Credit Factors articles. We propose to combine all sector-specific analytical adjustments into a guidance document, the proposed version of which is included in the appendix.

2. We propose revising five key terms as follows:

- Funds from operations (FFO): FFO will be calculated by taking adjusted EBITDA, minus cash interest paid minus cash tax paid. Our previous definition of FFO was adjusted EBITDA minus net interest expense minus current tax expense.
- Cash flow from operations (CFO): We propose eliminating our adjustments to CFO for pensions and asset retirement obligations.
- Discretionary cash flow (DCF): DCF will be depressed by share buybacks in addition to cash dividends paid on common and preferred stock. DCF will be calculated as free operating cash flow (FOCF) minus cash dividends paid on common and preferred stock, less share buybacks. Our previous definition was FOCF minus cash dividends paid on common and preferred stock.
- Cash interest paid: This will start with the cash interest paid 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. It is now a key component of our FFO calculation. Our previous definition of cash interest paid was primarily used for calculating the FFO cash-interest-cover ratio, and "cash interest" included only cash interest payments on gross financial debt (including bank loans, debt capital market instruments, finance leases, and capitalized interest).
- Capital: We have simplified our definition of capital to no longer adjust for deferred taxes.

3. Proposed revision to adjustment for leases

In order to align our analytical adjustment for operating leases to the new accounting, we propose to modify our adjustment to generally accept the balance sheet treatment for the U.S. generally accepted accounting principles

(U.S. GAAP) and International Financial Reporting Standards (IFRS) filers that will now capitalize all leases on the balance sheet by including the reported lease obligations in our adjusted debt. For U.S. GAAP filers that capitalize all leases, we will also adjust our income statement and cash flow measures to remove the distinction between finance leases and operating leases.

For those entities not required to capitalize operating leases on the balance sheet, we will continue to adjust our debt, earnings, interest, and cash flow measures for operating lease reporting.

In certain circumstances we may adjust the amount added to adjusted debt to better reflect the lease leverage. Our expectation is that, in most cases, the reported lease liabilities should be at least three times the next 12 months' lease commitments.

4. Proposed revision to adjustment for accessible cash
We are proposing to eliminate any reference to a 25% haircut in our current criteria. Instead, we will calculate our accessible cash adjustment on a company-specific basis using information about each company's quickly accessible cash holdings and investment portfolio.

5. Proposed revision to adjustment for post-retirement employee benefits and deferred compensation
We are proposing to eliminate the current interest expense calculation for U.S. GAAP issuers that mimics the IFRS net interest cost calculation. Instead, we will use the reported interest information under U.S. GAAP. The primary reason for this change is linked to our change in the FFO definition, which will be reduced by cash interest paid compared to an accrual-based interest expense under our previous definition, thereby not affecting FFO.

6. Finally, we propose eliminating the analytical adjustments listed below from our existing ratios and adjustments methodology because we have determined that they do not have a material impact on our financial metrics:

- Accrued interest;
- Convertible debt;
- Debt issuance costs;
- Fair value hedging;
- Performance guarantees;
- Debt adjustment for stock compensation payable in cash;
- Equity adjustment for post-retirement employee benefits, litigation, and guarantees;
- Last-in, first-out impact on inventory accounting (except on a sector-specific basis), and
- Interest expense for securitization, sale, and factoring of receivables and other assets.

We encourage interested market participants to submit their written comments on the proposed criteria by Feb. 4, 2019, to
http://www.standardandpoors.com/en_US/web/guest/ratings/rfc

where participants must choose from the list of available Requests for Comment links to launch the upload process (you may need to log in or register first). We will review and take such comments into consideration before publishing our definitive criteria once the comment period is over. S&P Global Ratings, in concurrence with regulatory standards, will receive and post comments made during the comment period to www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/requests-for-comment/filter/all#rfc .

We outline the proposed criteria in the article, "Request For Comment: Ratios And Adjustments," which can be found on RatingsDirect and on our website at www.standardandpoors.com under Actions & Criteria, Requests for Comment.

This report does not constitute a rating action.

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