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Criteria | Corporates | General:

Corporate Methodology: Ratios And Adjustments

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*(**Editor's Note:** We originally published this criteria article on Nov. 19, 2013. We republished this article on Oct. 31, 2014, to clarify a term in paragraph 104. We republished this article following our periodic review completed on Oct. 16, 2014. We republished this article to add a section on frequently asked questions. We republished this article on April 10, 2014, to correct the first bullet point in paragraph 174 regarding the lease disclosure requirements under International Financial Reporting Standards, and the second bullet point in the same paragraph to add that CFO, as well as FFO, are increased by adding back the depreciation expense. These corrections have no impact on our ratings.)*

1. Standard & Poor's Ratings Services is updating its criteria for making analytical adjustments to companies' financial data, following its "Request for Comment: Corporate Criteria: Ratios And Adjustments," published on June 26, 2013, on RatingsDirect. This criteria update relates to our global corporate criteria "Corporate Methodology," published on Nov. 19, 2013, and to the criteria article "Principles Of Credit Ratings," published on Feb. 16, 2011.

2. This criteria article supersedes "2008 Corporate Criteria: Ratios And Adjustments," published on April 15, 2008, and other articles, as listed in the Appendix.

I. SCOPE OF THE CRITERIA

3. These criteria apply to nonfinancial corporate entities we rate globally. It excludes project finance entities and corporate securitizations because of their unique characteristics.

II. SUMMARY OF THE CRITERIA

4. The analytical adjustments that Standard & Poor's makes to the reported financial results of companies worldwide allow for globally consistent and comparable financial data.

5. These adjustments also enable better alignment of a company's reported figures with our view of underlying economic conditions. Moreover, they allow a more accurate portrayal of a company's ongoing business, for example, following acquisitions or disposals, through pro forma adjustments.

6. There are general analytical adjustments that apply across multiple industries, but some are industry specific. The general adjustments are described in this criteria article, whereas the details of industry-specific adjustments are in the relevant criteria articles, labeled "Key Credit Factors."

III. IMPACT ON OUTSTANDING RATINGS

7. The impact of the new corporate criteria on ratings is described in the criteria article "Corporate Methodology," published on Nov. 19, 2013.

IV. EFFECTIVE DATE AND TRANSITION

8. These criteria are effective immediately.

V. METHODOLOGY AND ASSUMPTIONS

A. Reasons For Analytical Adjustments

9. A company's financial statements are the starting point of our financial analysis. Our analysis of a company's financial statements begins with a review of the accounting features to determine whether the data in the statements accurately measure a company's performance and position relative to that of its peers and the larger universe of corporate entities.

10. Understanding accounting frameworks such as International Financial Reporting Standards (IFRS), U.S. generally accepted accounting principles (U.S. GAAP), and other local or statutory GAAP, is therefore crucial to our corporate rating methodology. It is equally important to understand the differences between the accounting standards and how those differences can affect the reporting of economically equivalent transactions.

11. Accounting rules often provide options for the treatment of certain items, making the comparison of data difficult, even among companies using the same accounting frameworks. Moreover, business transactions have become increasingly complex, and so have the related accounting rules and concepts, which often involve greater reliance on subjective estimates and judgments.

12. In addition, several fundamental shortcomings of reporting requirements could reduce the quality and quantity of information in financial statements. One example relates to recognition and measurement: What circumstances determine whether an item such as a special-purpose entity or a synthetic lease should be reflected on or off a company's balance sheet, and at what value? Another example concerns transparency: What should a company disclose about the nature of off-balance-sheet commitments, compensation arrangements, or related-party transactions?

13. To allow for globally consistent and comparable financial analyses, our rating analysis includes quantitative adjustments to companies' reported results. These adjustments also enable better alignment of a company's reported figures with our view of underlying economic conditions. Moreover, they allow a more accurate portrayal of a company's ongoing business, for example following acquisitions or disposals, through pro forma adjustments.

14. Although our adjustments revise certain amounts that companies report under applicable accounting principles, this does not imply that we challenge 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 results for other purposes.

15. Rather, the methodology seeks to address a fundamental difference between accounting and analysis. An accountant

puts figures together in the form of financial statements. An analyst, by definition, picks the numbers apart and considers the implications of their components as well as the reported totals. It is rarely possible to completely recast a company's financial statements (so we do not attempt to apply double-entry accounting), but adjustments improve the relevance and consistency of the financial ratios we use in our analysis.

B. How And When Adjustments Apply

16. Certain adjustments pertain broadly to all industries because they apply to many types of companies at all times. These include adjustments for operating leases and postretirement employee benefits. Other adjustments may pertain only to a certain industry. Industry-specific adjustments are in the relevant criteria articles labeled Key Credit Factors.

17. In rare circumstances, consistent with the principles underpinning our explicit adjustments, we may make nonstandard analytical adjustments to depict a transaction differently from the reported financial statements or simply to increase the comparability of financial data across industries. For example, we may treat certain cash-raising transactions as akin to borrowing if they do not follow the standard trade terms of an industry and are in lieu of conventional debt issuance.

18. Our use of analytical adjustments depends on whether events and items a company reports could have a material impact on our view of the company's creditworthiness. Therefore, we may not make certain adjustments if the related amounts are too small to be material to our analysis.

19. Additionally, the transparency or extent of a company's disclosure in its financial statements may preclude adjustments to reported figures. For example, in many industries there is insufficient disclosure to allow full adjustments to income for inventory figures that reflect the "last in first out" valuation method.

C. Adjusted Debt Principle

20. Many of the analytical adjustments we make result from our view of certain implicit financing arrangements as being debt-like. Our depiction of these transactions as debt, which is often contrary to how a company reports them, affects not only the quantification of debt but also the measures of earnings and cash flows we use in our analysis. Therefore, it is instructive to understand the principles underpinning our adjustments to debt.

21. In general, items that we add to reported debt include:

- Incurred liabilities that provide no future offsetting operating benefit (such as unfunded postretirement employee benefits and self-insurance reserves);
- On- and off-balance-sheet commitments for the 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 or factoring of accounts receivable).

22. Many of the items that increase debt under the adjustments are 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.

23. Not all incurred liabilities are added to reported debt. The adjusted debt figure excludes short-term obligations, such as accounts payable and other accrued liabilities, because we regard them as trade credit rather than the incurrence of long-term debt. However, to the extent that a company defers payment beyond the term customary for its supply chain, we may add that amount to debt.

24. Additionally, we may exclude certain obligations a company reports as debt. This is, for example, because we perceive those obligations as equity rather than debt.

25. Companies' recognition and measurement of the numerous financing mechanisms vary. Some are reported at amortized cost (for example, issued debt), others at fair value (such as for contingent consideration), and others somewhere in between (as for pension obligations). Companies may also exclude certain financing from the balance sheet (such as operating leases). Ideally, we add to reported debt the amounts that approximate the amortized cost of commitments we consider to represent a debt, although from a practical standpoint this is not always possible.

26. Lastly, we may reduce the adjusted debt figure by netting surplus cash (see paragraphs 231-238).

D. Financial Ratios

27. The components of our ratios are derived from figures in companies' financial statements, subject to adjustments (subsequently referred to as "all applicable adjustments") defined in this criteria article and in the applicable Key Credit Factors articles. The definitions of the components are in the glossary (see paragraphs 248-263).

E. Analytical Adjustments

28. To calculate our financial ratios, we may make analytical adjustments related to the following:

- 1. Adjusted debt and interest

a) Accrued interest and dividends

b) Debt issuance costs

c) Debt at fair value

d) Fair-value hedging

e) Convertible debt

f) Foreign currency hedges of debt principal

g) Initial measurement of debt

- 2. Asset-retirement obligations
- 3. Capitalized development costs
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- 18. Workers' compensation and self-insurance

1. Adjusted debt and interest

29. In reflecting reported debt in our metrics, our objective is to use an amortized cost method, consistent with the amortized cost method under accounting standards like IFRS and U.S. GAAP. This method reflects debt as the amount of the original proceeds, plus interest calculated using the effective interest rate, minus payments of principal and interest. The effective interest rate is equivalent to the yield to maturity of a bond and takes into account the compounding of interest. This rate is consistent over the term of a fixed-rate debt instrument. For variable-rate debt, the effective interest rate after issuance will vary each time the coupon rate is reset. Under the amortized cost method, interest expense is measured at the full cost of the borrowing.

30. However, companies do not always report debt in this manner. Several factors can distort the measurement of debt, such as the exclusion of accrued and unpaid interest, the inclusion of debt-issuance costs, reporting debt at fair value, applying fair-value hedge accounting, and the method of accounting for convertible instruments. The use of different measures for debt may also result in interest expense amounts that differ from those under the amortized cost method. We make adjustments to the measurement of reported debt and interest in certain circumstances as described in paragraphs 31 to 70.

a) Accrued interest and dividends

31. We reclassify as debt any accrued interest that is not already included in reported debt. This adjustment enables a more consistent comparison among companies' financial obligations, by eliminating the disparity arising from differences in the frequency of interest payments (for example, quarterly rather than annually) or in payment due dates (for example, Jan. 1 or Dec. 31).

32. Additionally, we treat accrued interest or dividends on hybrid securities as debt. Deferred cumulative interest--whether the deferral was optional or mandatory--is also treated as debt.

Adjustment procedures

33. Data requirements:

- Reported accrued interest on debt, and dividends on hybrid securities, as of the balance-sheet date.

34. Calculations:

- Debt: Add to reported debt any accrued interest on debt and any dividends on hybrid securities.

b) Debt issuance costs

35. Debt issuance costs are a form of prepaid interest, which companies record on the balance sheet and amortize as an interest expense over the term of the debt. We regard them as part of the total cost of borrowing and therefore do not deduct the amortization of debt issuance costs from reported interest.

36. However, there are different approaches to where these amounts are reported on the balance sheet. A company may either report debt issuance costs as a separate asset, or deduct them from reported debt as a "contra liability" (that is, a liability with a debit balance, rather than the typical credit balance). We look to exclude these prepaid amounts from debt, when reported as a contra liability, to attain comparability. Similarly, if a company deducts premiums paid for modifications or redemptions from debt, we exclude those amounts from debt if practicable.

Adjustment procedures

37. Data requirements:

- Amount of debt issuance costs or modification premiums reported as a contra liability, which reduces reported debt.

38. Calculations:

- Debt: Add to reported debt the amount of debt issuance costs or modification premiums reported as a contra liability.

c) Debt at fair value

39. In certain circumstances, a company may report debt at fair value instead of at amortized cost. In such cases, we adjust the reported figure to reflect the amortized cost method. If the amortized cost figure is not shown in the financial statements, we may estimate it, based on the amount originally received or the face value plus accrued but unpaid interest.

40. In addition, we seek to exclude gains or losses from the revaluation of debt at fair value from our measure of interest expense. However, from a practical standpoint, if a company does not disclose these figures, it is difficult to adjust interest expense for the difference between the reported figure and the effective rate achieved by the amortized cost method.

41. When this difference is material, we may make estimates to arrive at a figure that approximates interest expense, exclusive of mark-to-market effects. We would make such an estimate by, for example, multiplying the face value of the obligation by an interest rate estimated from other similar debt instruments.

Adjustment procedures

42. Data requirements:

- The amount of debt using the amortized cost method (from the financial statements) or, if this is not available, an estimate based on the amount originally received or the face value plus accrued but unpaid interest.
- The amount of any charge or benefit for debt reported at fair value and recorded as an interest expense.

43. Calculations:

- Debt: Increase or decrease reported debt by the difference between the reported amount and our estimate of the amortized cost.
- Interest expense: Increase or decrease reported interest expense by the amount of any charge or benefit for debt reported at fair value and recorded as an interest expense.

d) Fair-value hedging

44. A company may issue fixed-rate debt and at the same time enter a derivative contract to synthetically create a variable-rate debt instrument. If all necessary conditions are met, companies may elect to apply fair-value hedge accounting to such an arrangement. The effect of this accounting approach is that a company would report both the derivative instrument and the debt (but only the risk being hedged) at fair value. Changes in the fair values of both items from one reporting date to the next are netted off against each other in the income statement.

45. When a company applies fair-value hedge accounting to debt, we adjust the reported debt figure to reflect the amortized cost method.

46. It is not necessary to adjust interest expense in this case because the fair-value adjustments the company makes in the income statement generally offset each other, and settlements under the derivative are reported as an interest expense.

Adjustment procedures

47. Data requirements:

- The debt figure expressed as the amortized cost amount in the financial statements.
- If this is not available, we (1) determine the amount of the fair-value adjustment made to reported debt as a consequence of hedge accounting; or (2) estimate the adjustment amount using the fair value of the related derivative instrument; or (3) adjust debt to reflect the amount originally received as proceeds or the face value plus accrued and unpaid interest.

48. Calculations:

- Debt: Increase or decrease debt by the difference between the reported amount and our estimate of debt under the amortized cost method.

e) Convertible debt

49. Due to their complex nature, we take a slightly different approach to measuring convertible debt instruments that give the holder the option of converting the debt into shares. Because of this option, the coupon rate on such obligations is normally lower than market interest rates.

50. Under U.S. GAAP and IFRS the value of a convertible debt obligation is split into a debt component and an equity

component (following the split-accounting method).

51. The debt component is the fair value of a similar debt obligation without the conversion feature. This amount is accounted for under the amortized cost method and increases toward the face value of the convertible debt instrument until maturity or conversion.

52. The equity component (the value of the conversion feature) represents the difference between the debt component and the issue price of the convertible debt instrument. The value of the equity portion remains constant.

53. Although uncommon, we may regard a convertible debt instrument as having equity content in our analysis, depending on its terms and conditions and our view of the likelihood that the debt holder will convert it to equity (see "Hybrid Capital Handbook: September 2008 Edition," published on Sept. 15, 2008). If we consider such an instrument to have high equity content, we reclassify it as equity. If we consider that there is minimal equity content, we treat the instrument fully as debt.

54. We typically add to reported debt the unamortized value of the discount created by the conversion option, bringing the value of such an instrument back to par.

55. In our ratios, we seek to include the full effective cost of the obligation as interest. We believe the interest resulting from the split-accounting method achieves this goal and therefore no adjustment is necessary.

56. If a company does not use split accounting we estimate the cost of debt by increasing reported interest expense when the difference in value under the other method is material.

Adjustment procedures

57. Data requirements:

- The face value of convertible debt instruments or the remaining unamortized discount as of the balance-sheet date.
- The amount of interest expense reported in the period, if we consider the instruments to have high equity content.

58. Calculations:

- Debt: Increase reported debt by the amount necessary to bring an instrument back to par. If an instrument has high equity content according to our criteria, we deduct the reported amount from debt.
- Interest: Subtract from interest the amount of interest expense on convertible debt considered to have high equity content.

f) Foreign currency hedges of debt principal

59. Foreign-currency-denominated debt is typically included in consolidated debt on the balance sheet at the amount of foreign currency, translated at the spot rate on the balance-sheet date.

60. Many companies hedge the foreign currency exposure by entering into derivatives that fix the foreign exchange rate that will apply on the debt's repayment date. To better reflect the economics of such transactions, we adjust the reported amount of foreign-currency-denominated debt to reflect the net amount required for repayment as a result of the hedge.

61. We may not make this adjustment if other factors can neutralize the benefit of the derivative. These factors include

concerns about risk relating to the derivative counterparty (such as when a derivative counterparty has credit quality equivalent to 'BB+' or lower) and other derivative contracts that can offset the benefit of the derivative hedge.

62. The adjustment amount results from restating the hedged debt principal using the "locked-in" foreign exchange rate achieved through the derivative. The adjustment amount is broadly equivalent to the fair value of a derivative representing a foreign currency hedge of debt principal, but may differ for various reasons, such as because the derivative's fair value also reflects liquidity and counterparty risk.

63. We use the derivative's value as a proxy for our adjustment amount if retranslation of the debt balance is not practical because of insufficient information.

64. However, companies often hedge the foreign currency exposure related to debt principal and interest simultaneously. In this instance, we take care to adjust only for the fair value of the derivative that hedges the principal, and not the portion that hedges the interest.

Adjustment procedures

65. Data requirements:

- The amount of hedged foreign-currency-denominated debt (from the balance sheet); and
- The locked-in foreign exchange rate (or locked-in principal value of outstanding debt) achieved via the hedge transaction.
- Alternatively, the fair value of the derivative that applies only to the principal (that is, excluding any fair value associated with hedged interest payments).

66. Calculations:

- Debt: Retranslate foreign-currency-denominated debt using the locked-in foreign exchange rate (or adjust the balance-sheet value of debt to equal the locked-in principal value). Alternatively, add to or subtract from reported debt the fair value of the hedging instrument on the balance-sheet date.

g) Initial measurement of debt

67. We subscribe to amortized cost as the preferred method of measuring debt after debt is issued. However, in certain circumstances, we may take an alternative view toward a company's initial measurement, and therefore ongoing measurement, of a particular debt instrument, as described in the next paragraph.

68. Companies usually initially measure debt at an amount equal to the net proceeds received at issuance. However, there are other methods of initial measurement of debt that we believe can in certain instances distort the initial and ongoing carrying value of debt. This may include the methods applied to debt assumed in an acquisition, or debt that has been modified or is part of a distressed exchange. When our judgment about the initial measurement (and therefore ongoing measurement) of a debt instrument differs from a company's, we may adjust debt, funds from operations (FFO), and interest expense if practical and the effect is material.

Adjustment procedures

69. Data requirements:

- Initial measurement of the applicable debt instrument.

- Our assumed measurement of the applicable debt instrument.
- Interest expense associated with the applicable debt instrument that is reported during the period.
- Interest expense for the period, based on our assumed initial measurement of the applicable debt instrument.

70. Calculations:

- Debt: Increase or decrease debt by the difference between the reported amount of debt and our estimate of amortized cost based on our assumed initial measurement.
- Interest expense: Increase or decrease interest expense by the difference between reported interest expense and the estimated interest expense based on our assumed initial measurement.
- FFO: Increase or decrease FFO by the difference between reported interest expense and the estimated interest expense based on our assumed initial measurement.

2. Asset-retirement obligations

71. Asset-retirement obligations (AROs) 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, and treating or storing spent nuclear fuel and capping and restoring mining and waste-disposal sites.

72. We treat AROs as debt-like obligations, although several characteristics distinguish them from conventional debt, including timing and measurement uncertainties.

73. A company's liability for AROs is independent from the amount and timing of the cash flows the associated assets generate. In certain situations, companies fund AROs by adding a surcharge to customer prices; or the AROs are paid by third parties, such as a state-related body. In these cases there would typically be no debt adjustment.

74. The measurement of AROs involves a subjective assessment and is therefore imprecise. We generally use the reported ARO figures, but we may make adjustments for anticipated reimbursements, asset-salvage value, or any of the company's assumptions we view as 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.

75. Under most accounting standards, company balance sheets show the ARO figure before tax, and any expected tax benefits as a separate deferred tax asset on the balance sheet (because the associated ARO-related asset is subject to depreciation). Tax savings that coincide with settling ARO payments (as opposed to their provisioning), reduce the cash cost of the AROs, and we factor them into our analysis to the extent that we expect the company to generate taxable income in the same tax jurisdiction.

76. Our approach is to add AROs--after deducting any dedicated retirement-fund assets or provisions, salvage value, and anticipated tax savings--to debt. We generally adjust for the net aggregate funding position, even if some specific obligations are underfunded and others are overfunded. The adjustment amounts are tax effected (that is, adjusted for any tax benefit the company may receive) if the company will likely be able to use tax deductions.

77. The accretion of an ARO that reflects the time value of money is akin to noncash interest and similar to postretirement benefit interest charges. Accordingly, we reclassify the accretion (net of earnings on any dedicated funds), using a floor of zero for the net amount as interest expense, in analyzing the income and cash flow statements.

78. If dedicated funding is in place and the related returns are not entirely reflected in reported earnings and cash flows,

we add the unrecognized portion of the related returns to earnings and cash flows. We reclassify the recognized portion to interest expense and cash flow from operations (CFO).

79. We treat cash payments for the abandonment of assets and contributions to dedicated funds that exceed ARO interest costs (after deducting ARO fund earnings) as repayment of the ARO. We therefore add these amounts to FFO and CFO.

80. We treat cash payments for the abandonment of assets and contributions to dedicated funds that are less than the ARO interest costs (after deducting ARO fund earnings) as the incurrence of a debt obligation. We therefore deduct the shortfall in payments from FFO and CFO.

Adjustment procedures

81. Data requirements:

- The ARO figure (from the financial statements or Standard & Poor's estimate).
- Any associated assets or funds set aside for AROs.
- ARO interest costs irrespective of whether charged to operating or financing costs.
- The reported gain or loss on assets set aside for funding AROs.
- Any cash payments for AROs.

82. Calculations:

- Debt: Add net ARO to debt (net ARO equals the reported or estimated ARO minus any assets set aside to fund AROs, multiplied by 1 minus the tax rate).
- EBITDA: Add ARO interest costs included in operating costs.
- Interest: Deduct ARO interest costs (net of ARO fund earnings) from reported operating expenses, if included there, and add to interest expense.
- FFO: Our definition of FFO is EBITDA minus net interest expense minus current tax expense, after adjusting each of the three components according to our criteria. EBITDA and interest expense are adjusted as described in the previous two bullet points. The figure to adjust the current tax expense results from multiplying the applicable tax rate by the net result of (1) new provisions, plus (2) interest costs, minus (3) the actual return on funded assets, minus (4) fund contributions or ARO payments in the corresponding period. The net effect of these adjustments is that FFO is reduced by net ARO interest and adjusted for tax effects.
- CFO: Subtract the gain (or add the loss) on assets set aside for AROs from interest expense. Then compare the resulting amount with payments on the AROs to arrive at the excess contribution or shortfall to add to, or subtract from, CFO. Additionally, we adjust CFO for tax effects in a similar way as for FFO.

3. Capitalized development costs

83. In financial reporting, research costs are almost universally treated as an expense; however the treatment of development costs varies. U.S. GAAP, with limited exceptions (such as for software development costs in certain instances), requires companies to treat development costs as an expense, whereas IFRS allows such costs to be capitalized under certain conditions. In addition to these differences between accounting regimes, there is an element of subjectivity in determining when development costs are capitalized, which can lead to a disparity among companies' reported figures.

84. To enhance the comparability of data, we adjust reported financial statements when a company capitalizes

development costs, if the information is available and the amounts material. The adjustment aims to treat the capitalized development costs as if they had been expensed in the period incurred.

85. We aim to adjust EBITDA, FFO, and CFO for the amount of development costs capitalized during the year. This is because a company's position in its product life cycle has a great effect on its current spending relative to the amortization of previously capitalized development costs. However, in the absence of accurate figures, we use the annual amortization figure reported in the financial statements as a proxy for the current year's development costs. To the extent that the amortization of previously capitalized costs equals current development spending, there is no impact on operating expenses and EBIT because these amounts are after amortization. However, there is an impact on EBITDA, FFO, and CFO, which are calculated before amortization.

86. We do not carry through the adjustment to the cumulative asset (and equity) accounts, weighing the complexity of such adjustments against their typically limited impact on amounts that are secondary to our analysis.

87. We make one exception to this approach, and that is for capitalized development costs relating to internal-use software. Consistent with our goal of achieving comparability, we do not want to create a gap between companies that develop software for internal use and those that purchase software and capitalize equivalent products. We therefore attempt to exclude such costs from our adjustment.

Adjustment procedures

88. Data requirements:

- Amount of development costs incurred and capitalized during the period, excluding, if practical, capitalized development costs for internal-use software.
- Amortization amount for relevant capitalized costs.

89. Calculations:

- EBITDA, FFO, and CFO: Subtract the amount of net capitalized development costs or, alternatively, the amortization amount for that period.
- EBIT: Subtract (or add) the difference between the spending and amortization in the period.
- Capital expenditures: Subtract the amount capitalized in the period.

4. Capitalized interest

90. Under most major accounting regimes, financial statements show interest costs related to the construction of fixed assets as capitalized, that is, as a component of the historical cost of capital assets. This can obscure the total interest that has been incurred during the period, hindering comparisons of the interest burden of companies that capitalize and do not capitalize interest.

91. Under our methodology, interest costs that have been capitalized are adjusted and included as interest expense in the period in which the interest was incurred.

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

93. We make no adjustment for the cumulative effect on the value of property, plant, and equipment resulting from any prior-year interest capitalization, tax effects, or depreciation, due to disclosure limitations and the minimal analytical benefit this would provide.

Adjustment procedures

94. Data requirements:

- The amount of capitalized interest during the period.

95. Calculations:

- Interest expense: Add amount of interest capitalized during the period.
- FFO: Our definition of FFO is EBITDA minus net interest expense minus current tax expense, after adjusting each of the three components according to our criteria. Net interest expense includes the interest capitalized during the period, as described in the previous bullet point. Therefore, FFO is reduced by the amount of interest capitalized in the period.
- CFO: Subtract the amount of capitalized interest recorded as an investing cash flow.
- Capital expenditures: Subtract the amount of capitalized interest recorded as an investing cash flow.

5. Financial and performance guarantees

a) Financial guarantees

96. 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. A guarantee can be limited or unlimited. If a company has guaranteed liabilities of a third party or an unconsolidated affiliate, we may add the guaranteed amount to the company's reported debt.

97. We do not add the guaranteed amount to debt if the other party is sufficiently creditworthy (that is if the other party has credit quality equivalent to 'BBB-' or higher) in its own right, or we believe that the net amount payable if the guarantee were called 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. In this case, we add the lower amount to debt. We do not adjust interest expense because the guarantor is only obliged to service interest if called upon to meet the guarantee.

b) Performance guarantees

98. A performance guarantee is a promise to provide compensation if a company does not complete a project or deliver a product or service according to the agreed terms. An insurance company or bank may issue such guarantees on a company's behalf. Construction companies often provide performance guarantees to meet a condition in a work contract. If the project, product, or service is not completed as agreed, the customer can call on the performance guarantee.

99. We do not regard performance guarantees as debt if a company is likely to maintain sufficient work or product quality to avoid making large payments under those guarantees.

100. A company's past record of payments under performance guarantees could indicate the likelihood of future payments under such guarantees. Only if this payment history suggests a high likelihood of future payments would we estimate a potential liability and add that amount to debt.

Adjustment procedures

101. Data requirements:

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

102. Calculations:

- Debt: Add to debt the amount of on- and off-balance-sheet debt-equivalent related to guarantees, net of any tax benefit.
- Equity: Subtract from equity the amount of off-balance-sheet debt-equivalent related to guarantees, net of any tax benefit.

6. Hybrid capital instruments

103. Hybrid capital instruments (or hybrids) have features of both debt and common equity. We classify a corporate hybrid as having minimal, intermediate, or high equity content depending on the specific terms and conditions of the instrument and our view of whether the issuer intends to maintain the instrument as loss-bearing capital. Our classification of equity content determines the type of adjustments we make to a company's reported figures.

104. A company's issuance of conventional hybrids, in an aggregate amount of up to 15% of capitalization, can be eligible for equity credit, which means that we exclude at least some of the hybrid instrument and its interest costs from our debt and interest measures (see "Hybrid Capital Handbook: September 2008 Edition," published on Sept. 15, 2008). We exclude bonds that are mandatorily convertible into shares from this calculation. Capitalization is equal to balance-sheet equity, plus debt and hybrids, after adjusting for goodwill and making all applicable adjustments. The capitalization calculation excludes any goodwill asset that exceeds 10% of total assets.

105. The treatment of hybrids for the purposes of our leverage and debt service ratio calculations depends on the equity content classification:

- Hybrids that have high equity content are treated as equity 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% as equity (excluding unpaid accrued interest or dividends, which are added to debt). Similarly, we treat one-half of the period's interest or dividends as dividends and one-half as interest. There is no adjustment to related taxes.
- Hybrids with minimal equity content are treated entirely as debt and all interest or dividends as interest.

106. In all cases, accrued coupon payments are treated as debt.

107. The criteria for adjustments related to convertible debt are in paragraphs 49-58 of this article and in "Hybrid Capital Handbook: September 2008 Edition," published on Sept. 15, 2008.

Adjustment procedures

108. Data requirements:

- Documentation for reported hybrid capital instruments.
- 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 accrued unpaid interest or dividends.

109. Calculations:

- Hybrids reported as equity: (1) If we classify equity content as high, there is no adjustment to equity. (2) If we classify equity content as intermediate we deduct 50% of the value from equity and add it to debt. We also deduct 50% of the dividend accrued during the accounting period and add it to interest expense, thereby reducing FFO. Likewise, 50% of any dividends paid are deducted from CFO. (3) If we classify equity content as minimal, we deduct the full principal amount from equity and add it to debt. We add associated dividends to interest expense, thereby reducing FFO. Likewise dividends paid are added to interest paid, thereby reducing CFO.
- Hybrids reported as debt: (1) We deduct the value of hybrids with high equity content from debt and add it to equity. We also deduct the associated interest charge from interest expense and add it to dividends, thereby removing it from FFO. Likewise, interest paid is added to CFO and dividends. (2) If we classify equity content as intermediate, we deduct 50% of its value from debt and add it to equity. We also deduct 50% of the associated interest expense from interest expense and add it to dividends accrued, thereby increasing FFO. 50% of interest paid is added to CFO. (3) If equity content is minimal there is no adjustment because we treat such hybrids as debt.
- Debt: We add to debt the accrued and unpaid interest and dividends on all hybrids.

7. Inventory accounting methods

110. Accounting frameworks allow companies a choice of inventory accounting method, and this leads to reporting differences within industries and among regions. The disparity is more pronounced in inventory-intensive industries, particularly when the price of inventory (such as raw materials) fluctuates significantly. This is because the method a company uses influences the amount of inventory it can charge as an expense, and therefore also its taxable income. The inventory accounting methods under U.S. GAAP are "first in first out" (FIFO), "last in first out" (LIFO), weighted-average cost, and specific identification.

111. Similar costing methods exist in other generally accepted accounting principles. However, many frameworks, including IFRS, do not allow LIFO. The tax treatment is a key factor in a company's choice of inventory costing method and it varies significantly by jurisdiction. For example, LIFO is permitted for tax-reporting purposes in the U.S., and a company that uses it for tax purposes must also use it for preparing its financial statements.

112. The greatest potential disparity in financial results comes from using FIFO as opposed to LIFO. When inventory prices are rising, the LIFO method results in lower income than under FIFO because the most recent and higher cost of goods is transferred to the income statement, while the remaining inventory is shown at the older, lower cost on the balance sheet. Furthermore, LIFO results in improved cash flows for that period because income taxes are lower as a result of the lower taxable income.

113. Apart from hindering comparison between different companies, the different methods can also obscure a company's true performance record. For example, LIFO arguably allows for a more realistic depiction of current costs on the income statement, but showing inventory at older costs distorts the balance-sheet position. The FIFO method, on the other hand, provides a more up-to-date valuation of inventory on the balance sheet, but can significantly understate the cost of goods sold during a period of rising prices and overstate income.

114. We adjust the reported inventory figures if material to our analytical process. Companies that use LIFO have to disclose what the inventory valuation would be under FIFO, through an account called the LIFO reserve that represents the cumulative effect on gross profit from the use of the LIFO method. For such companies, we add the

balance in the LIFO reserve to the reported inventory. This enables us to reflect inventory balances at approximately the current market value. A corresponding adjustment, net of tax, is made to equity.

115. We do not adjust the income statement when a company uses LIFO because we believe the LIFO method results in costs of goods sold that closely reflect replacement-cost values.

116. Typically, there are no adjustments to the income statement for companies that use FIFO or the average cost method because the data are generally not available.

117. When a company using the LIFO method has inventory balances that decrease over a period of time, LIFO liquidation may result. This means that older layers of inventory are turned into cost of goods sold as a result ("older" refers to inventory in terms of their 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 liquidation gains. To capture the true sustainable profitability of a company, we generally exclude the gains generated from LIFO liquidation from our profitability measures.

Adjustment procedures

118. Data requirements:

- The balance of the LIFO reserve account.
- LIFO liquidation gains from the income statement.

119. Calculations:

- Assets: Add the LIFO reserve to inventory.
- Equity: Add the LIFO reserve (after tax) to equity.
- EBITDA, EBIT, and FFO: Deduct LIFO liquidation gains from EBITDA, EBIT, and FFO.

8. Litigation

120. If a company is a defendant in a major lawsuit, we may adjust its debt to account for the potential cost when an adverse outcome (payment of a cash settlement or damages) is probable or has materialized. If the estimated or known amount of the potential payment is material in relation to the company's cash flow or leverage ratios, we add that figure to reported debt. Before doing so, we may reduce the potential payment to reflect the expected reimbursement from legal insurance coverage, cash held in reserve, and extended payment dates; or add accruing interest penalties.

121. The adjusted debt figure therefore includes the present value of the net estimated payout, on an aftertax basis.

122. To achieve the difficult task of sizing the litigation exposure, we may use as a reference any resolved lawsuits that can serve as benchmarks. We also consider the company's reported litigation reserves and the different thresholds for their recognition under IFRS and U.S. GAAP.

123. Because the full financial effects of a lawsuit are difficult to quantify accurately, the analysis also involves techniques such as calculating ranges of outcomes or performing a sensitivity analysis. The results of these techniques can indicate, for example, what effect even higher potential payouts would have on a company's financial profile.

124. If, to allow for a possible adverse financial judgment, a company has placed cash in escrow with the courts or is

expected to do so; or if it had to provide a financial guarantee to the courts, we incorporate the impact of this actual or contingent commitment into the liquidity assessment.

Adjustment procedures

125 Data requirements:

- An estimate or actual amount of the litigation exposure.

126 Calculations:

- Debt: Add the estimated or actual amount of litigation exposure (net of any applicable tax deduction) to reported debt.
- Equity: Subtract the amount of estimated litigation exposure considered to be debt-like that exceeds the accrued litigation exposure, if any.

9. Multi-employer pension plans

127 Some companies in the U.S. participate in multi-employer, defined-benefit pension plans on behalf of their employees. Such companies are predominantly in the transportation, building, construction, manufacturing, hospitality, and grocery sectors. The pension plans are often are referred to as "Taft-Hartley" plans because they fall under the Taft-Hartley Labor Act (officially termed the "The Labor Management Relations Act") of 1947.

128 A multi-employer pension plan is forged by a collective bargaining agreement between companies that generally operate in the same sector and the union(s) that represent the sector's workers. These arrangements share many of the attributes of single-employer plans.

129 We regard the liability associated with a funding deficit on multi-employer pension plans as debt, as we do deficits on single-employer defined-benefit, postretirement obligations. For practical reasons, and because of a lack of pertinent data, we generally do not adjust cash flow measures in our analysis unless significant catch-up contributions are made; nor do we generally adjust our profitability measures.

a) Unique characteristics of multi-employer pension plans

130 Multi-employer pension plans pose some unique challenges, mainly because they are complex, and information about them in companies' financial statements is limited. For example, unlike for single-employer plans, there is generally no information on a company's potential share of a shortfall under a multi-employer plan, unless that company is withdrawing from the plan. Further, because the plans are collective, the sponsoring companies may become liable beyond their otherwise pro rata share of the obligation if another company becomes insolvent.

131 These challenges make it difficult to estimate the amount each company might have to pay to meet current and future obligations under such plans. It is therefore crucial to gather additional information that is timely and relevant, including the specific features of the plan and the collective bargaining process.

132 A company participating in a multi-employer plan faces problems that a company sponsoring a single-company pension plan does not, in particular if it wants to withdraw from such a plan. Companies that withdraw from an underfunded multi-employer plan may incur a withdrawal liability representing their pro rata shares of the total underfunded pension obligation. Determining the withdrawal liability amount accurately is difficult because statutes

provide several different ways to calculate it. Moreover, special rules in certain industries (such as construction, entertainment, and trucking) determine the withdrawal liability trigger points and the size of the obligation. For example, the withdrawal liability may be limited in cases such as a bona fide sale of substantially all of the employer's assets or the company's liquidation or dissolution.

133. A solvent company that exits an underfunded multi-employer pension plan generally continues to make payments for its share of the liabilities for as many years as the Employee Retirement Income Security Act specifies. However, if a company is insolvent, the other participating companies must assume all of its obligations. For single-employer plans, the sponsoring company is liable only for the underfunded portion of its own plan.

134. All of these factors make it difficult to estimate the amount of a company's potential liability under a multi-employer plan to add as debt. To do so, we consider the facts and circumstances associated with the plan. For example, instead of a pro rata share of the collective obligation, we may estimate a lower amount if we view it as plausible that the plan's trustees could reduce the plan's total liability over time by decreasing the level of future employee benefits. We primarily base this determination on information from the company and publicly available data.

b) Accounting and disclosure limitations

135. Under U.S. GAAP and IFRS, a company's withdrawal liability must be both probable and estimable for it to be recognized as a contingent liability in the financial statements. This obligation is therefore seldom accrued or disclosed.

136. Financial statement disclosure on multi-employer plans is typically limited to the significant plans an employer participates in, the company's annual contributions to each plan over the previous three years, and the relative financial health of the plans as indicated by regulatory guidelines.

137. Using publicly available tax and regulatory filings to approximate the funded status of a multi-employer pension is also problematic, considering filing delays. Plans must file Form 5500 (Annual Return/Report of Employee Benefit Plan) with the U.S. Department of Labor. This form provides useful data about a plan's overall financial health, its funding status, number of participants, and contribution levels. However, the form must be filed within 210 days after the end of the plan year (subject to a 75-day extension), and there may be an additional time lag before the Department of Labor publishes the information. The resulting data will therefore be somewhat out of date. In particular, in the period before the publication of the data, fluctuations in discount rates, market returns, and the terms of collective bargaining agreements, participation levels, and other actuarial assumptions may result in changes in the financial health of the plan that the filings do not reflect.

Adjustment procedures

138. Data requirements: Where material, obtain an estimate of the withdrawal liability for each plan a company participates in. If this figure is unavailable, we make an estimate of the company's pro rata share of the funded status based on the following information:

- The funded status of each of the multi-employer plans to which the company contributes. This information may be provided by the company for more recent years, or it may be obtained from the publicly available Form 5500s filed with the Department of Labor. To estimate the funded status, we use the Retirement Protection Act of 1994 liability, minus the fair value of assets as of the same date.

- The company's contributions to each of its multi-employer plans in the corresponding years.
- The total contributions to the multi-employer pension plan by all employers in the corresponding years.
- An applicable haircut for anticipated negotiations.

139. Calculations:

- Debt: Add the estimated withdrawal liability for all plans, net of tax, to debt. Alternatively, if not available, add to debt the estimate of the employer's share of the funded status of each plan (net of any applicable haircut and net of tax).

10. Nonoperating activities and nonrecurring items

140. We define our key income-statement-based metrics (EBITDA, EBIT, and FFO) in a particular fashion. However, the reported financials often do not conform to our views. Therefore it is necessary for us to adjust the reported financial information so that they fit in with our methodology.

a) Operating versus nonoperating items

141. Our decision to include or exclude an activity from a particular metric depends on whether we consider that activity to be operating or nonoperating in nature (see paragraphs 142-158). Independent of that decision, we consider whether an activity is recurring or nonrecurring (see paragraphs 159-164).

142. Our EBIT measure is a traditional view of profit that factors in capital intensity. We consider all income statement activity integral to EBIT, with the exception of interest and taxes. This includes all activity we consider nonoperating that is excluded from EBITDA.

143. Our definition of EBITDA is: Revenue minus operating expenses plus depreciation and amortization (including noncurrent 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. This definition generally adheres to what EBITDA stands for: earnings before interest, taxes, depreciation, and amortization. However, it also excludes certain other income statement activity that we view as nonoperating.

144. Our definition of EBITDA aims to capture the results of a company's core operating activities before interest, taxes, and the impact on earnings of capital spending and other investing and financing activities. This definition links to the cash flow statement because we use EBITDA to calculate FFO, which we use as an accrual-based proxy for CFO (cash flow from operations).

145. Generally, this means that any income statement activity whose cash effects have been (or will be) classified as being from operating activities (excluding interest and taxes) are included in our definition of EBITDA.

146. Conversely, income statement activity whose cash effects have been (or will be) classified in the statement of cash flows as being from investing or financing activities is excluded from EBITDA.

147. We may however take alternative views about the classification of transactions to that presented in the statement of cash flows, and this would flow through to our other metrics.

148. Below are examples of how we apply this principle to various scenarios.

149. ***Disposals:-*** Under accounting standards, proceeds from the sale of a subsidiary are classified in the statement of cash flows as an investing cash flow rather than an operating cash flow. Moreover, we view the disposal of a subsidiary as outside core business operations. As such, we do not treat a gain or loss from the sale of a subsidiary as an operating activity and exclude this from our calculation of EBITDA and FFO.

150. The same rationale holds for the sale of property, plant, and equipment. The cash flows arising from such transactions are classified, under accounting standards, as investing activities in the statement of cash flows. Therefore, we would typically view any gains or losses on the sale of property, plant, and equipment as nonoperating items.

151. ***Restructuring costs:-*** We include restructuring costs in our calculation of EBITDA, consistent with their treatment in the cash flow statement as operating activities. Moreover, most companies need to restructure at some point, as the global economy is constantly evolving and businesses alter their operations to remain competitive and viable.

152. ***Acquisition-related costs:-*** These include advisory, legal, and other professional and administrative fees related to an acquisition. We include them in EBITDA, consistent with their treatment in the statement of cash flows as operating activities. Many businesses make acquisitions as part of their growth strategy; therefore it is important to factor these expenses into our metrics.

153. ***Asset impairments/write-downs:-*** Impairments on tangible and intangible noncurrent assets are akin to depreciation or amortization in that they represent a company's income-statement recognition of earlier capital expenditures. We therefore exclude them from our definition of EBITDA. Our definition of EBIT includes impairment charges or reversals. Our decision to exclude an impairment cost or reversal from EBIT would depend on whether we consider it to be recurring or nonrecurring (see paragraphs 159-164).

154. However, impairments on current assets, such as inventory and trade receivables, are included in our calculation of EBITDA. The charges for inventory represent a company's recognition in the income statement of cash that it has already spent, and those for trade receivables represent the reduction of income previously recognized, but which the company will not fully collect.

155. ***Unrealized gains or losses on derivatives:-*** If a company has not achieved the requirements of technical hedge accounting (even though an effective economic hedge may exist), it reports all mark-to-market gains or losses related to the fair-valuing of derivative contracts in the income statement. Although the nature of the underlying activity is often integral to EBITDA, FFO, or both, using mark-to-market accounting can distort these metrics because the derivative contract may be used to hedge several future periods.

156. Therefore, when we have sufficient information, we exclude the unrealized gains or losses not related to current-year activity, so that the income statement represents the economic hedge position achieved in the current financial year (that is, as if hedge accounting had been used). This adjustment is common in the utilities and oil and gas sectors.

157. ***Foreign currency transaction gains and losses:-*** Foreign currency transaction gains or losses arise from transactions denominated in a currency other than a company's functional currency (generally the currency in which it transacts most of its business). Examples include selling goods at prices denominated in a foreign currency, borrowing or lending in a foreign currency, or other contractual obligations denominated in a foreign currency.

158. Currency transaction gains and losses may be viewed as operating or nonoperating in nature. If gains or losses included in operating profit are operating in nature, we do not make adjustments. We may however adjust reported operating results for currency gains and losses that are nonoperating. For example, we may adjust (or exclude) foreign currency gains or losses resulting from the issuance of foreign-currency-denominated debt.

b) Nonrecurring items and pro forma figures

159. The relative stability or volatility of a company's earnings and cash flow is an important measure of credit risk that is embedded in our corporate criteria. For this reason, our use of nonrecurring or pro forma adjustments is limited to the extent that there has been some transformative change in a company's business. Examples of such changes are the divestment of part of the business or a fundamental change in operating strategy.

160. ***Discontinued operations and business divestments:-*** Companies typically segregate their profits or losses from discontinued operations from those of the continuing business; although the segregation of related cash flows is less consistent. 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.

161. ***Pro forma accounts for intrayear acquisitions or irregular reporting periods:-***If an acquisition has taken place, the financial statements for the year of the acquisition include all the debt of the enlarged group in the year-end balance sheet, but less than the full year's results and cash flows of the enlarged group. This distorts debt-coverage ratios, which therefore do not accurately indicate the company's likely future performance.

162. A similar issue exists when companies have irregular accounting periods, such as after a change in their accounting 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.

163. ***Asset impairments and write-downs:-*** We generally exclude impairment charges on long-life assets from our measure of EBIT if they are very large and irregular. Excluding a nonrecurring impairment from EBIT produces a better estimate of a company's ongoing profitability, but does not mean we ignore the impairment in our analysis. On the contrary, a significant impairment may indicate that a company's ability to generate future cash flows has diminished.

164. We rarely exclude impairments of operating assets, such as inventories and receivables, from our EBITDA and FFO metrics because we wish to capture this volatility. An exception might be a genuine nonrecurring impairment, such as inventory impairment resulting from damage caused by a fire.

Adjustment procedures

165. Data requirements:

- Amounts of income, expense, and cash flows to be reclassified. The amounts are based on our analytical judgment, using information from the company and our assessments.

166. Calculations:

- Add or subtract amounts from the respective measures--such as, revenue, operating income before and after depreciation and amortization (D&A), D&A, EBIT, EBITDA, CFO, and FFO--and reclassify them according to our view of the underlying activities.
- Because CFO and FFO are aftertax measures, they are also adjusted to reflect tax effects, where feasible.

167. Beyond the standard adjustment, additional insights may be gleaned by adjusting individual line items within cost of goods sold or selling, general, and administrative expense, if there is sufficient data to reflect adjustments at such levels.

11. Leases

168. Companies commonly use leases as a means of financing, and the accounting method for leases distinguishes between operating and finance leases. Finance leases (also known as capital leases) are accounted for in a manner similar to a debt-financed acquisition of an asset and as a balance-sheet liability. Conversely, many operating leases are not accounted for as a balance-sheet liability, but the lease cost is recorded in the profit and loss account in each accounting period.

169. We view this accounting distinction as substantially artificial because under both types of lease arrangements, a company signs a contract that allows it to use an asset, thereby entering into a debt-like obligation to make periodic rental payments.

170. For this reason, we treat operating and finance lease obligations as debt. Reclassifying leases as debt seeks to enhance comparability between companies that finance assets using operating or financing leases and those that do so by incurring debt to finance the purchase of the asset. This adjustment aims to bring companies' financial ratios closer to the underlying economics and to make them more comparable by taking into consideration all of a company's financial obligations, whether on or off the balance sheet.

171. The methodology does not replicate a scenario in which a company finances the acquisition of an asset with debt. Rather, the adjustment is narrower in scope: It attempts to capture only a debt-equivalent for a company's lease contracts. For example, when a company enters into a five-year lease for an asset with a 20-year productive life, the adjustment includes only payments relating to the contracted five-year lease period. We do not use alternative methodologies that fully capitalize the value of the asset, given disclosure and other limitations.

172. However, if we view the term of a lease as artificially short relative to the length of expected use of the leased asset, we may make adjustments to reflect a more economically appropriate depiction of the underlying lease obligation. An example of this approach is for sale-and-leaseback transactions, where if practical we capitalize the entire sale amount.

Adjustment procedures

173. Data requirements:

- Minimum lease payments: The schedule of noncancellable future lease payments over the next five years and beyond (and residual-value guarantees if not included in minimum lease payments).
- Reported annual lease-related operating expenses for the most recent year.
- Deferred gains on sale-and-leaseback transactions that created operating leases.
- We use a fixed discount rate of 7% for all corporate entities we rate. Theoretically, the discount factor could be calculated as the weighted average of the implicit interest rates (that is, the rates charged by the lessors) in each of the company's operating lease arrangements. This is not practicable, however, given accounting disclosure limitations.
- 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.

174. Calculations (operating leases):

- Debt: We add to debt the present value of future lease payments, 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 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. IFRS allow companies to disclose amounts payable in years two through five as a single combined amount, instead of separate amounts for each year. In this case, we assume a flat annual payment amount in years two through five, based on the total minimum lease payment disclosed for these four years. We consider future lease payments to be net of sublease rental income only if the lease and sublease terms match and the holder of the sublease is sufficiently creditworthy (that is, has credit quality equivalent to 'BBB-' or higher).

- Income statement and cash flow measures: The lease-related expense is allocated to interest and depreciation expense. EBITDA is increased by adding back the interest and depreciation expense. EBIT is increased by adding back the interest expense. FFO and CFO are increased by adding back the depreciation expense. Gains or losses on sale-and-leaseback transactions are excluded from these measures.
- Interest expense: 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 years.
- Capital expenditures: Our base calculation of capital expenditures, and therefore free operating cash flow (FOCF), excludes any implied capital expenditures relating to operating leases. For lease-intensive sectors, we may use a separate FOCF measure, which includes a capital-expenditure operating lease adjustment, to compare companies' lease and purchase decisions. For this separate FOCF measure, the capital expenditures figure is increased by an implied amount of capital expenditures relating to leases, calculated as the year-over-year change in lease debt, plus annual operating lease depreciation. This amount cannot be negative.
- Property, plant, and equipment: We add the amount of operating leases we reclassify as debt to property, plant, and equipment to approximate the depreciated asset cost.

175 Calculations (finance leases):

- Debt: To the extent that they are not already included in reported debt, we add to debt, finance lease obligations and any obligation associated with failed sale-and-leaseback transactions.
- Capital expenditures: Our base calculation of capital expenditures, and therefore FOCF, excludes any implied capital expenditures relating to finance leases. For lease-intensive sectors, we may use a separate FOCF measure, which includes a capital-expenditure finance lease adjustment, to compare companies' lease and purchase decisions. For this separate FOCF measure, capital expenditures are increased by the value of assets acquired via finance leases during the period.

12. Postretirement employee benefits and deferred compensation

176 We include underfunded defined-benefit obligations for retirees, including pensions and health care coverage (collectively, postretirement benefits or PRB) in our measure of 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 debt because they represent financial obligations that must be paid over time.

177 The adjustments we make relate solely to existing obligations, rather than to potential future obligations.

178 Unlike debt, the measurement of PRB obligations is inherently uncertain: The amount of benefits payable and the value of any assets earmarked to fund those obligations fluctuate over time.

179 To simplify the numerical analysis, 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.

180. We tax-effect our PRB adjustment amounts (that is, give credit for associated 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 or, if this is unavailable, the current corporate rate, even though the actual effect of tax charges or benefits in the future may be different. In a typical situation, the company has credible prospects of generating sufficient future taxable income to take advantage of tax deductions related to PRB and so reduce future tax payments.

181. We do not tax-effect the adjustment amounts if we consider a company's ability to generate profits uncertain. Moreover, in such cases, our main focus is the company's liquidity, rather than its capitalization or debt-coverage levels.

a) Capital structure

182. We adjust capitalization for PRB effects by adjusting both debt and equity, where applicable. Debt is increased by the company's tax-effected unfunded PRB obligation. In the instances where equity does not reflect the full extent of the underfunded deficit, equity is adjusted by the difference between the amount accrued on the corporate balance sheet and the amount of net over- or underfunded obligation (net surplus or deficit), net of tax. Debt is not adjusted downward for net surpluses, so net overfunding (surplus) leaves debt unchanged. Equity can be adjusted upward (if the net recognized asset is less than the pretax surplus) or downward. We do not split the debt adjustment between short and long term.

b) Cash flow

183. With PRB and deferred compensation plans, companies are effectively compensating their employees by issuing debt. Our cash flow view is that companies are constructively borrowing from the employees and paying the employees an amount equal to service costs. Additionally, because there is an interest element to the amount borrowed, our cash flow measures assume that imputed interest is paid as incurred. This approach takes a normalized view of cash flows: That is, regardless of when the pension plan is funded over the life of the plan, service costs and net interest costs are paid when incurred.

184. With that in mind, if a company is funding postretirement obligations at a level that is below its net expense (service cost and net interest cost), we interpret this as a form of borrowing that artificially bolsters reported CFO. Conversely, we try to identify catch-up contributions made to reduce unfunded obligations, which would artificially depress reported CFO. We view these contributions as akin to debt amortization, which represents a financing cash flow rather than an operating cash flow.

c) Income statement

185. For the purposes of arriving at income statement measures, we disaggregate the periodic benefit cost into its component parts, allocate those amounts to operating and financing components, and eliminate components we believe are not indicative of the current year's activity. 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, such as within operating expenses.

186. Under U.S. GAAP, the expected return on plan assets represents management's subjective, long-range expectation about the performance of the investment portfolio. This concept has been abandoned under IFRS, which under revised

accounting standards, now calculates a net interest figure by multiplying the deficit (or surplus) on the PRB by the discount rate. For the purposes of global comparability, we make adjustments to the reported data of companies still incorporating an expected return element into their interest calculations, such as those reporting under U.S. GAAP, to mimic the IFRS method of calculating net interest. This measure of PRB interest, if a net expense, is added to reported interest. No adjustment is made if net interest is a net income item.

Adjustment procedures

187 Data requirements (for adjustments to income and cash flow items):

- Service cost;
- Interest cost;
- Expected return on pension plan assets, if applicable;
- Actuarial gains or losses (amortization or immediate recognition in earnings);
- Prior service costs (amount included in earnings);
- Other amounts included in earnings (such as special benefits, settlements, and curtailments of benefits);
- Total benefit costs; and
- The sum of employer contributions and direct payments to employees.

188 Data requirements (for adjustments to balance-sheet items):

- PRB-related assets on the balance sheet, including intangible assets, prepaid or noncurrent assets, or any other assets;
- Reported liabilities attributed to PRB, including current and noncurrent liabilities;
- Deferred tax assets related to PRB (or the tax rate applicable to related costs);
- Fair value of plan assets; and
- Total plan liabilities.

Note: Relevant pension and other PRB amounts are combined for all plans.

189 Calculations (income statement and cash flows):

- Operating income: Add to EBIT and EBITDA the total amount of PRB costs charged to operating income, less the current service cost.
- Interest: PRB interest is the net interest cost as reported by companies under IFRS, or as we estimate for companies reporting under U.S. GAAP and other companies using the expected-return approach. If PRB interest is a cost, we include it in adjusted interest expense (we do not reduce interest expense if PRB interest is an income item). This PRB interest is added to reported interest when the net benefit costs are included in operating income. If reported interest already includes an interest component for PRB we adjust it, if necessary, to ensure it reflects the amount of PRB interest.
- Tax expense: We add to, or subtract from, reported tax expenses any tax charge or benefit that results if a company makes additional contributions to postretirement plans or falls short of planned contributions for the current year.
- FFO: FFO equals EBITDA minus net interest expense, minus current tax, with our analytical adjustments applying to each of the three components. EBITDA is adjusted for PRB as described in the first bullet point of this paragraph, while the adjusted net interest expense includes the PRB net interest cost or credit. The current tax expense is adjusted to reflect any tax benefit or charge that the company has received through making excess or insufficient contributions. The net effect of this is that FFO is reduced by the sum of current service costs and net PRB interest, adjusting for tax effects.

- CFO: The adjustment to CFO starts with a calculation of excess contributions or PRB borrowing: Total employer cash contributions (including direct payments to retirees), minus current service costs, minus PRB interest yields the excess contribution if positive, or PRB borrowing if negative. The excess contribution or PRB borrowing is reduced by taxes at the rate applicable to PRB costs (that is, the figure multiplied by 1 minus the tax rate) to create the adjustment amount to CFO. The excess contribution or PRB borrowing is added to, or subtracted from, CFO.

190 Calculations (balance sheet):

- Debt: The net balance sheet asset or liability position (funded status) is calculated as the balance-sheet PRB assets minus PRB liabilities. For the adjustment to debt, if the net pension and postretirement funded status is positive, debt is not adjusted. If the net pension and postretirement funded status is negative, this amount is reduced by the expected tax shield, that is, the amount is multiplied by 1 minus the tax rate. The resulting net amount is added to debt.
- In some jurisdictions, the tax benefit is realized in advance of funding the deficit or paying benefits, for example, when the liability is accrued for tax purposes. The expected tax shield used in our calculation only takes into account amounts that have not yet been received. The adjustment to equity also considers existing balance-sheet amounts.
- Equity: We add to, or subtract from, equity the tax-effected difference (that is, after multiplying that figure by 1 minus the tax rate) between the deficit or surplus on the PRB plan and the reported net plan assets and liabilities.

13. Scope of consolidation

191 When analyzing the creditworthiness of a group, a first critical step is to determine the manner in which a company reports the results of its subsidiaries and affiliates (including their operations, cash flows, assets, and liabilities) in its financial statements. There are several accounting methods to reflect a company's relationship with another company: full consolidation, proportionate consolidation, equity-method consolidation, and deconsolidation (that is, accounted for as an investment).

192 Full consolidation of a subsidiary entails including 100% of each line item of its income, cash flows, assets, and liabilities in the group's financial statements. When a parent owns less than 100% of a subsidiary, the non-controlling-interest holder's share is shown on a separate line in the consolidated income statement and balance sheet.

193 Proportionate consolidation of an affiliate is when all line items of a parent's financial statements include its pro rata share of the affiliate's income, cash flows, assets, and liabilities. This method of consolidation is not common in accounting, but we use it from time to time if we believe that proportionate consolidation best reflects a company's business and financial ties with subsidiaries and affiliates.

194 The equity method of consolidation involves showing the parent's share of profits (or losses) on one line in the income statement, and the parent's investment (initial price paid plus the post-acquisition share of changes in the affiliate's net assets) on the balance sheet. Only cash dividends are reflected in the parent's cash flow statement.

195 Reporting as a nonconsolidated (or deconsolidated) investment means the parent company shows the value of the investment on its balance sheet, typically measured at cost or fair value. The parent does not include any of the income of that affiliate in its results, but reports cash dividends received in the cash flow statement.

196. Although most often the scope of consolidation we employ when analyzing a company is the same as that in the company's financial statements, we may use any consolidation method that in our opinion best reflects a company's business and financial ties with its subsidiaries and affiliates. The analytical adjustments would therefore serve to convert the reported figures to those consistent with our chosen method.

197. No single factor determines our analytical view of a company's relationship with a particular business venture. Rather, the decision will reflect an assessment of factors that, taken together, will lead to a particular characterization. These factors include:

- Strategic importance--integrated lines of business or critical supplier;
- Percentage of ownership (current and prospective);
- Management control;
- Shared name;
- Domicile in the same country;
- Common sources of capital and lending relationships;
- Financial capacity for providing support;
- Significance of the amount of investment;
- Investment relative to the amount of debt at the affiliate or project;
- Position of the other owners (whether strategic or financial investment) and their financial capacity;
- Management's stated stance toward the affiliate or project;
- Whether the creditors of the subsidiary or affiliate have recourse to the parent;
- Shared collective bargaining agreements;
- The bankruptcy-law regimes applicable to the parent and subsidiary;
- Track record of the parent company in similar circumstances; and
- The nature of potential risks.

Adjustment procedures

198. Because a company can use various consolidation methods, there is no standard adjustment procedure. We adjust the reported figures to reflect our quantitative view of the group.

14. Securitization and factoring

199. Securitization can be an important financing vehicle for many companies, potentially enhancing liquidity and enabling them to diversify their funding sources. An important factor is whether the assets and liabilities of a securitization are shown on a company's balance sheet, or deconsolidated and reported as an off-balance-sheet transaction.

200. We may reconsolidate a securitization that a company reports as off-balance-sheet financing. This is because securitizations do not ordinarily transform the risks or the underlying economic reality of the business activity, nor do they necessarily provide equity relief, which allows the company to retain less equity or incur more debt than would otherwise be the case, without affecting its credit quality.

201. If a securitization accomplishes true transfer of risk (contractual, legal, and reputation risk), as is the case with securitization of a tax asset, we regard the transaction as an asset sale and make no adjustments, subject to the considerations in paragraphs 202-206.

202. More commonly, a company retains risks related to the assets transferred under the securitization transaction. We

regard such transactions as being akin to secured financing and bring them back onto the balance sheet if the company has treated them as off-balance-sheet items. The analysis also indicates whether the securitization creates a disadvantage for a company's unsecured creditors that would affect our rating on unsecured debt issues.

203. For example, in our analysis, we treat as on-balance-sheet items, securitization of assets (such as trade receivables) that are regenerated in the ordinary course of business and financed on an ongoing basis. This is because the assets and trading relationships these assets represent are an integral part of a company's operations. Even if a transaction legally transferred risks related to a pool of assets and the company has no obligation to support failing securitizations, this does not mean the company would receive equity relief or that we would not reconsolidate the securitization in our analysis. If a company has a recurring need to finance similar assets, we do not presume it will have permanent access to the securitization market. The company may have to meet future funding needs by other means, and therefore have the requisite equity (and the equivalent level of borrowings) to do so.

204. We treat factoring (or invoice discounting) of trade receivables in a similar way, by including the trade receivable asset and the associated funding liability in the company's balance sheet.

205. Other key considerations for the adjustment of securitizations include:

- The riskiness of the securitized assets. If, as is often the case, a company securitizes its highest-quality or most liquid and therefore low-risk assets, this would limit the extent of any meaningful equity relief, and may create subordination of unsecured creditors, which if significant enough could have an impact on our rating on unsecured debt.
- First-loss exposure. A company may retain liability for a defined portion of loss from a securitization (known as "first-loss exposure"), thereby providing structural credit protection for the securitized asset, which would lower funding costs. The first-loss layer may absorb much of the risk of the securitized asset, and the total gain or loss from the securitization will vary depending on the performance of the assets. Often, only the risk of loss that exceeds the first-loss exposure is transferred to third-party investors.
- Moral recourse. This refers to the likelihood that a company will support a securitization although not legally obliged to do so. Our assessment of moral recourse reflects our view of how a company could behave if losses on the securitization reached catastrophic levels. There is evidence to suggest that companies often tend to bail out troubled securitization transactions (for example, by repurchasing problematic assets or replacing them with other assets) to preserve access to this funding source and, more broadly, to preserve their good name in the capital markets. Moral recourse is magnified when securitizations make up a significant portion of a company's total financing, or when a company remains linked to the securitized assets through the use of a shared corporate name or by continuing in the role of servicer or operator. If we regard the likelihood of moral recourse as significant, we regard the securitized asset and liability as part of the company's balance sheet.

206. The adjustments to a company's financial statements also depend on the extent of risk transfer resulting from a securitization:

- If a company retains most of the risk, our cash flow/leverage ratio calculations include the securitized debt, regardless of whether the securitized debt was reported as on-balance-sheet debt or accounted for as an off-balance-sheet transaction.
- If the company retains none of the risk, the securitized assets are not regenerated in the ordinary course of business, and there are no contingent or indirect liabilities resulting from the transaction, we view the securitization as

equivalent to an asset sale and exclude it from our analysis of the company. This means that if a company has consolidated such a transaction, we use adjustments to remove the securitization assets, debt, earnings, and cash flows from the reported consolidated results in our analysis. We also adjust shareholders' equity, including for the effect of deferred taxes and imputed (or assumed) interest.

207. Several factors limit our ability to make full adjustments for securitizations. When a company reports a securitization as an asset sale in its financial statements, this may create an upfront gain or loss on the sale. When we reconsolidate such a securitization, it is appropriate to reverse such gains because of the uncertainty about whether they will be realized and because they represent nonrecurring income. Likewise, we reverse any loss on the sale that reflects the discount on the sale, to prevent double counting the interest component of the transactions.

208. To calculate the imputed interest, we generally estimate an interest rate because of insufficient information. That rate approximates the interest rate on similar transactions.

209. It is impractical to fully recast the financial statements to consolidate off-balance-sheet securitizations because companies are not required to include pro forma schedules including the securitization transaction in their published accounts.

210. Under U.S. GAAP and IFRS, companies report cash inflows or outflows related to working-capital assets or liabilities, or finance receivables, as operating items on the statement of cash flows. Consequently, securitizations of assets such as receivables affect CFO, and the effect may be particularly significant in reporting periods when the securitizations are initiated or mature.

211. The reporting convention varies with the balance-sheet classification. If a company consolidates a securitization, the related borrowings are treated as a financing activity. If the securitization is off the balance sheet, the effect is akin to accelerated liquidation of the associated assets. There is no separate record of the incurrence of debt, either as an operating liability or a financing source of cash.

212. When our approach is to consolidate a securitization (or, in rare situations, to deconsolidate a securitization), we adjust the cash flow statement to smooth out the variations in CFO that can result from the treatment of a securitization as a sale, which can distort the pattern of recurring cash flow.

Adjustment procedures

213. Data requirements:

- The period-end amount and average outstanding amount of trade receivables sold or securitized that are not on the balance sheet and require adjustments according to our criteria.

214. Calculations:

- Debt and receivables: Add the amount of period-end trade receivables sold or securitized (that is, the uncollected receivables as of the balance-sheet date) to reported debt and receivables.
- Interest expense: Add to interest expense the amount of imputed interest, calculated using the average trade receivables sold over a two-year period (if the data are available) or the trade receivables sold as of the period-end date, at an appropriate benchmark interest rate.
- CFO: Deduct from CFO the proceeds from the securitization if the transaction results in large cash flow movements,

such as on the creation of a securitization or subsequent changes in amounts securitized. Rolling over an existing securitization requires no cash flow adjustment.

15. Seller-provided financing

215. Companies acquiring other companies sometimes finance a portion of the purchase price (or consideration), via seller-provided financing and/or entering into contingent consideration arrangements (that is, "earn outs"). We often view these transactions as a form of financing and therefore we make analytical adjustments to reflect this view. The accounting approach under U.S. GAAP is materially consistent with that under IFRS.

216. The most straightforward form of seller-provided financing is a loan reported at amortized cost plus interest. We include the reported debt amount and interest expense in our respective measures to the extent that they are not already reported as such. No adjustment is necessary on the statement of cash flows, apart from any interest reported under IFRS outside of CFO.

217. The reporting of contingent consideration is more convoluted given the complexity and variability of the instruments. Contingent consideration can take many forms: It can be paid in cash or shares, it can be contingently payable by the acquirer or prepaid and contingently returnable to the acquirer, or it can be contingent upon the recipient's continued employment with the acquirer after the acquisition. The nature and terms of an arrangement dictate the accounting for the arrangement and our analytical treatment.

218. Contingent consideration payable in shares is generally reported within equity and is not remeasured in reporting periods subsequent to the transaction. We do not add to debt an amount for the anticipated settlement of these transactions because we consider them to be prospective equity issuance.

219. Contingent consideration that is prepaid and contingently returnable to the acquiring entity results in an asset on the acquirer's balance sheet that is marked to market in each accounting period until settled. We make no adjustments for these arrangements because they are effectively receivables with no potential future cash outlay. However, we would adjust CFO if the acquirer reported any returned consideration within CFO.

220. Contingent arrangements that require continued employment are technically not part of the consideration paid for the acquisition under U.S. GAAP and IFRS. Rather, such 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. The recognized expense is a component of our EBITDA and FFO, and its ultimate payment should reduce CFO. Additionally, we do not adjust the reported debt figure unless the original term of the liability was greater than 12 months.

221. Our primary focus is on contingent consideration that is payable in cash, or contracts to be settled in shares that do not qualify as equity. The most common example is a contract to be settled with a variable number of shares. Companies typically record such arrangements, initially, as a liability at fair value and subsequently mark them to market at the end of each accounting period via 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 it is not at amortized cost.

222. Consistent with our view of cash flows, described in the next paragraph, we exclude the charges or credits to income from our measurement of EBITDA and FFO, on the basis that this recognition of measurement uncertainty in the income statement is not a core operating cost, but an additional cost of the acquisition. We generally do not attempt to make adjustments to interest expense; such adjustments are usually impractical because interest on the contingent consideration is typically not disclosed.

223. When a company ultimately pays the contingent consideration to the seller, it may report the cash outflow in several ways in the statement of cash flows. We regard these outflows as investing cash flows because they represent cash paid for the purchase of a business. Any cash settlements reported in other ways (for example, as operating or financing cash flows) will be adjusted to reflect this view.

Adjustment procedures

224. Data requirements:

- The carrying value of seller-financed debt or liability-classified contingent consideration on the balance-sheet date.
- Charges or credits included in reported EBITDA.
- Cash paid for or received from the settlement of contingent consideration reported either in cash flows from operating activities or cash flows from financing activities.

225. Calculations:

- Debt: Add to debt, to the extent not already reported as such, the carrying amount of seller-financed debt at amortized cost, as well as any liability-classified contingent consideration reported at fair value.
- EBITDA: If charges or credits from the change in fair value of contingent consideration are included in reported EBITDA, add them back to or subtract them from EBITDA.
- CFO: If cash settlements are reported in CFO, remove the outflow because we consider it an investing activity (acquisition of businesses).

16. Share-based compensation expenses

226. Most major accounting regimes require companies to report the fair value of equity-based grants (such as stock options and restricted share awards) as an expense in the income statement. This amount is generally expensed over the benefiting period, that is, the period over which the company estimates the employee is providing services in exchange for the award.

227. Our cash-flow measures, such as CFO, are not affected by share-based grants payable in shares, given their inherent noncash nature. Additionally, we add back stock-based compensation that is payable in shares to EBITDA and FFO. Our key cash flow/leverage ratios--FFO to debt and debt to EBITDA--therefore exclude stock option expense related to arrangements payable in shares.

228. Certain other share-based arrangements, unlike options or restricted share awards, are payable solely in cash. Examples are stock appreciation rights that are required to be settled in cash, which represent a future call on a company's cash flow. Because they are payable in cash, we do not add back the expense related to these arrangements to EBITDA and FFO. We treat obligations under these arrangements as debt.

Adjustment procedures

229. Data requirements:

- Total share-based compensation expense reported in the period that is payable in shares.
- In jurisdictions that do not require the expensing of such compensation, an estimate of the expense.

230. Calculations:

- EBITDA: If a company has accounted for noncash stock compensation costs as an expense, we add that figure back to EBITDA.
- Operating income, before and after D&A, and EBIT: In jurisdictions that do not require companies to report share-based compensation as expenses, we estimate an expense amount and deduct it from these measures.
- Debt: Add to debt share-based arrangements payable solely in cash.

17. Surplus cash

231. We apply a standard method of calculating surplus cash, which is the amount of cash and liquid investments that is subtracted from gross debt to calculate debt.

232. Standard & Poor's payback ratios are intended to capture the degree to which a company has leveraged its risk assets. Highly liquid financial assets are often low risk. Moreover, we consider that, in addition to cash flow generation, surplus cash is available to repay debt, providing additional flexibility that enhances a company's credit quality. Therefore, it is appropriate to evaluate debt net of surplus cash.

233. Our standard methodology for calculating surplus cash allows the netting of available cash and liquid investments if in our judgment they are highly liquid, and if they are accessible; that is, the cash and liquid investments are truly surplus and therefore could be used to repay debt immediately.

234. We analyze the specifics of a company's cash holdings to evaluate how much of its cash is immediately accessible to reduce debt. To calculate how much cash can be netted off from debt, and unless we get enough information or identify analytical reasons supporting either a lower or higher haircut, we will deduct 25% from the available cash (A), identified as "cash and liquid investments" in "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers," published on Nov. 19, 2013, to reflect cash that is inaccessible. If we apply the default 25% haircut, adjusted cash (B) available for netting from gross debt would be A x 0.75 = B.

235. We identify cash that might be inaccessible due, among other reasons, to:

- Being held in a nonconvertible currency to the currency of a company's borrowings;
- Distribution restrictions (for example, covenants or cash held in escrow);
- Cash trapped at subsidiaries;
- Tax effects on the repatriation of cash;
- Period-end timing differences unrelated to working capital; or
- Being held in a country whose country risk we assess as high (country risk score of 5) or very high (country risk score of 6), and is in a different currency from the currency of the company's borrowings.

236. If available information indicates greater or lesser accessibility to cash and liquid investments, the haircut would be raised or lowered. For example, the haircut would increase if a company holds a large proportion of cash abroad in a

nonconvertible currency, or if the marginal tax payable on repatriation would exceed 25%. On the other hand, the haircut percentage would be lowered if, for example, detailed analysis showed that the amount of cash and liquid investments accessible on short notice would be higher than our standard assumption, or if any tax payable on repatriation of the cash and liquid investments would be at a rate of less than 25% and we believed that no other factors make the cash and liquid investments inaccessible.

237 If we forecast that a company will generate negative cash flow available for debt repayment, our cash flow/leverage criteria places greater reliance on the current year and the first and second forecast years (see paragraph 117 in "Corporate Methodology," published on Nov. 19, 2013). Forecast negative cash flows could stem from operating activities as well as share buybacks, dividends, or acquisitions, if we forecast these uses of cash based on the company's track record.

238. We will generally not deduct surplus cash from debt if a company is (1) owned by a financial sponsor as defined in Section H.2 of "Corporate Methodology," published on Nov. 19, 2013, or (2) has a business risk profile assessment of "weak" or "vulnerable." However, we deduct surplus cash from debt even if a company meets either of these conditions, as long as:

- We believe that the company has surplus cash identified 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.

18. Workers' compensation and self-insurance

239. Workers' compensation schemes provide compensation for employees injured in the course of employment. Although schemes differ across jurisdictions, provisions may be made for payments to employees in lieu of wages, compensation for economic losses (past and future), reimbursement for, or payment of, medical and similar expenses, general damages, and benefits payable to the dependents of workers killed during employment.

240. Workers' compensation coverage may be provided through insurance companies, and therefore is not a financial concern for the company. But, in certain instances and/or industries, employers assume direct responsibility for payments such as medical treatment or lost wages.

241. In these cases, under U.S. GAAP or IFRS, the company reports incurred liabilities on the balance sheet as "other liabilities," using an actuarially determined present value of known and estimated claims. Accordingly, these obligations represent a call on future cash flow, distinguishing them from many other less-certain contingencies. They are analogous to postretirement obligations, which we also add to debt.

242 Treating the workers' compensation liability as debt affects many line items on the financial statements. Ideally, if there is sufficient information in the statements, we would make full adjustments, using the same approach as for postretirement employee benefits (see paragraphs 176-190). In practice, the data is not available, so we reclassify these obligations, adjusted for tax, as debt. We may also treat similar self-insurance-type liabilities as debt.

Adjustment procedures

243. Data requirements:

- Net amount reported as a liability for workers' compensation obligations and self-insurance claims.

244 Calculations:

- Debt: Add to debt, the amount recognized for workers' compensation obligations (net of tax) and the net amount recognized for self-insurance claims (net of tax).

F. Index Of Key Ratios

245 Core debt-payback ratios:

- Funds from operations (FFO)/debt
- Debt/EBITDA

246 Supplemental debt-payback and debt-service ratios:

- Cash flow from operations (CFO)/debt
- Free operating cash flow (FOCF)/debt
- Discretionary cash flow (DCF)/debt
- (FFO + interest)/cash interest (FFO cash interest cover)
- EBITDA/interest

247 Profitability ratios:

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

VI. GLOSSARY

248 ***Capital:*** Debt plus noncurrent deferred taxes plus equity (plus or minus all applicable adjustments).

249 ***Capital expenditures:*** Funds spent to acquire or develop tangible and certain intangible assets (plus or minus all applicable adjustments).

250 ***Cash interest:*** For the purposes of calculating the FFO cash-interest-cover ratio, "cash interest" includes only cash interest payments on gross financial debt (including bank loans, debt capital market instruments, finance leases, and capitalized interest). Cash interest does not include any Standard & Poor's-adjusted interest on debt-like obligations, such as postretirement benefit obligations or operating leases.

251 ***CFO (cash flow from operations):*** CFO is also referred to as operating cash flow. This measure reflects cash flows from operating activities (as opposed to investing and financing activities), including all interest received and paid, dividends received, and taxes paid in the period (plus or minus all applicable adjustments). For companies that do not use U.S. GAAP, we reclassify as CFO any dividends received, or interest paid or received, that a company reports as investing or financing cash flows.

252 ***Current tax expense:*** This is the amount of income taxes payable on taxable profit, or income tax recoverable from tax losses, in an accounting period (plus or minus all applicable adjustments). Current tax expense is to be distinguished from deferred tax expense.

253 ***DCF (discretionary cash flow):*** FOCF minus cash dividends paid on common stock and preferred stock (plus or minus all applicable adjustments).

254 ***Debt:*** Gross financial debt (including items such as bank loans, debt capital market instruments, and finance leases) minus surplus cash (plus or minus all applicable adjustments).

255 ***Dividends:*** Dividends paid to common and preferred shareholders and to minority interest shareholders of consolidated subsidiaries (plus or minus all applicable adjustments).

256 ***EBIT:*** A traditional view of profit that factors in capital intensity, but also includes interest income, the company's share of equity earnings of associates and joint ventures, and other recurring, nonoperating items (plus or minus all applicable adjustments).

257 ***EBITDA:*** A company's revenue minus operating expenses, plus depreciation and amortization expenses, including impairments on noncurrent assets and impairment reversals (plus or minus all applicable adjustments). Dividends (cash) received from affiliates, associates, and joint ventures accounted for under the equity method are added, while the company's share of profits and losses from these affiliates is excluded.

258 ***Equity:*** Common equity and equity hybrids and minority interests (plus or minus all applicable adjustments).

259 ***FFO (funds from operations):*** EBITDA, minus net interest expense minus current tax expense (plus or minus all applicable adjustments).

260 ***FOCF (free operating cash flow):*** CFO minus capital expenditures (plus or minus all applicable adjustments).

261 ***Interest:*** This is the reported interest expense figure, including noncash 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 (plus or minus all applicable adjustments).

262 ***Net interest expense:*** This is the reported interest expense figure, including noncash interest on conventional debt instruments (such as payment-in-kind, zero-coupon, and inflation-linked debt), minus the sum of interest income and dividend income (plus or minus all applicable adjustments).

263 ***Revenues:*** Total sales and other revenues we consider to be operating (plus or minus all applicable adjustments).

VII. APPENDIX

264 This criteria article supersedes:

- "2008 Corporate Criteria: Ratios And Adjustments," published on April 15, 2008;
- "Methodology And Assumptions: Standard & Poor's Revises Key Ratios Used in Global Corporate Ratings Analysis," published on Dec. 28, 2011;
- "Recognizing The Settlement Obligation For Foreign-Currency Hedges Of Debt Principal," published on April 15, 2010;
- "Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates," published on Feb. 10, 2009;
- "Calculating Adjusted Debt And Interest For Corporate Issuers," published on June 2, 2008;
- "Standard & Poor's Approach To Analyzing Employers' Participation In U.S. Multi-Employer Pension Plans," published on May 30, 2006;
- "Analytical Approach To Postretirement Liabilities of Japanese Companies," published on March 31, 2003; and

- "Camouflaged Share Repurchases: The Rating Implications Of Total-Return Swaps And Similar Equity Derivatives," published on Dec. 7, 2000.

265. This criteria article partly supersedes the section Accounting And Financial Reporting in "2008 Corporate Criteria: Analytical Methodology," published on April 15, 2008.

Frequently Asked Questions

A. Surplus cash

Is the 25% deduction from cash and liquid investments, as described in paragraph 234, the standard amount Standard & Poor's uses to arrive at surplus cash and calculate adjusted debt?

No. The 25% deduction from cash and liquid investments should only be used if we do not have information that would enable the calculation of a more precise amount. If available information indicates greater--or lesser--accessibility to cash and liquid investments than what is assumed by the 25% deduction, we'd lower or raise the amount of the deduction. The deduction should only represent cash at the balance sheet date that is inaccessible to pay interest or repay debt in case of need. Often, we would expect the deduction to be less than 25%.

Can it be appropriate to have a different deduction from cash and liquid investments in arriving at surplus cash each year?

Yes, a different deduction from cash and liquid investments each year is often appropriate. We deduct from cash and liquid investments the amount of cash and liquid investments we believe is, or will be, inaccessible. That amount may not remain constant so a different percentage in each year can better reflect reality.

When developing the deduction from cash and liquid investments to arrive at surplus cash, do you exclude a minimum amount of cash necessary to run the business from the deduction? Could such a minimum amount of cash qualify as "cash trapped at subsidiaries," as noted in paragraph 235?

Generally no. When calculating surplus cash, cash and liquid investments should not be reduced 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. In addition, as working capital investment should be "self-extinguishing" or "self-liquidating"--as stock and debt (i.e. inventory and receivables) are converted into cash--it is not appropriate to increase debt for working capital investment needs by reducing cash and liquid investments in the calculation of surplus cash. However, to the extent that we believe that some of the company's working capital investment won't be "self-extinguishing"--due to factors such as stock write-offs, stock discounting, or bad debts--this would be captured in weaker profits in the base-case forecast, which would reduce cash flows and future cash balances. In addition, such working capital investment needs would not qualify as "cash trapped at subsidiaries." An exception to this approach could be where a company has indicated to us an operational cash requirement such that 'cash in the tills' is not practically accessible because it is needed to operate their business (examples include a supermarket who needs cash in tills, or a casino who needs to retain cash in cages). In such cases, we treat this cash need as part of the 'cash trapped at subsidiaries' condition (see paragraph 235).

Do you consider future events (e.g., large expected cash outflows related to capital expenditures, acquisitions, share buybacks and dividends, or lower forecasted earnings) in developing the haircut to gross cash and liquid investments in a particular period?

No. The haircut to gross cash and liquid investments is only for matters of inaccessibility, not future events or needs.

The expected cash outflow or reduced earnings should be included in the base-case forecasts. This will reduce forecast cash flows and period-end cash balances.

Should the haircut applied to liquid investments consider the taxes that would be incurred upon the sale of liquid investments?

Yes. The same principle we apply when tax-effecting cash held overseas should apply here. If the issuer needs to sell liquid investments to generate cash to pay interest or repay debt, the cash that would be received and would be available to pay interest and repay debt would be the net amount of cash after any taxes payable.

Paragraph 235 states that "We identify cash that might be inaccessible due, among other reasons, to…distribution restrictions (for example, covenants or cash held in escrow…)". Are there cases where Standard & Poor's could net off cash that is subject to distribution restrictions from gross debt to calculate debt? If so, do the qualitative preclusions to deducting surplus cash noted in paragraph 238 apply?

Yes, there can be situations where we net off cash that is subject to distribution restrictions from gross debt as part of the surplus cash adjustment--if the cash is restricted for the benefit of creditors with obligations that we include in debt. In these cases, the qualitative restrictions on giving surplus cash credit do not apply, just as they do not apply to netting off other committed assets such as pension assets. For example, if the purpose of the cash distribution restriction is to retain the cash for the benefit of counterparties to debt or debt-like obligations that are otherwise included in our adjusted debt metric, such restricted cash could be netted off gross debt. For example, cash held in escrow for the benefit of debtholders would be fully netted off from debt if the debt is included in Standard & Poor's debt calculation. Additionally, if the exclusion of restricted cash from cash and liquid investments in the calculation of surplus cash would run counter to one of our other analytical adjustments, the restricted cash could be netted off gross debt. An example of this is a cash-collateralized letter of credit facility whereby an issuer overfunds a term loan and places the excess funds in escrow as a back stop for letters of credit or performance guarantees. As long as we believe that the company will not have to make payments under the guarantee, such cash would be eligible for netting against gross debt. This is because, as paragraphs 99 and 100 state, "We do not regard performance guarantees as debt if a company is likely to maintain sufficient work or product quality to avoid making large payments under those guarantees. A company's past record of payments under performance guarantees could indicate the likelihood of future payments under such guarantees. Only if this payment history suggests a high likelihood of future payments would we estimate a potential liability and add that amount to debt."

If an issuer that Standard & Poor's classifies as volatile or highly volatile under the cash flow/leverage criteria has a large amount of surplus cash on hand during a favorable part of the industry cycle, but based on historical evidence you expect it will use most of that cash to meet operating needs during periods of stress, do you take this into account in the surplus cash analysis?

No. When calculating surplus cash, we would only haircut cash and liquid investments by the amount of any of the cash and liquid investments that are inaccessible. Any expected future uses of cash can be captured in the base-case forecast. If an issuer is assessed under the cash flow/leverage criteria to be volatile or highly volatile, then the cash flow/leverage assessment could be modified by one or two categories weaker (as per paragraph 124, section 5, of "Corporate Methodology," published Nov. 19, 2013).

B. Non-operating activities and non-recurring charges

What types of events constitute "transformative events" for the purpose of adjusting for non-recurring items? Is this the same threshold used in the cash/flow leverage criteria, and if so why is there a need to adjust if the weighted average is going to exclude history?

A transformative event is any event that could cause a material change in a company's financial profile. Examples of such changes are the divestment of part of the business or a fundamental change in operating strategy. The idea of a transformative event in these criteria is a similar concept to that contained in paragraph 112 of "Corporate Methodology." When transformative events have occurred and there is sufficient disclosure such that pro forma historical financials are representative of the ongoing entity, historical periods can be used in the cash flow leverage weighted average. Conversely, if the transformative event so alters the business or contorts the historical financials--such that analytical adjustments to historical financials cannot be reasonably employed to in effect pro forma the historical results to be representative of the ongoing entity--then adjustments will not be attempted. Instead, our cash flow leverage analysis will rely on the forecasted periods as described in paragraph 112 of "Corporate Methodology."

Do you adjust for certain accounting anomalies on a regular basis? Do these distortions for "measurement effects" or "accounting distortions," which can lead to misleading figures in the annual financial statements, qualify for adjustment under the non-recurring criteria despite not meeting the "transformative" threshold?

While such distortions are not transformative events per se, we do make adjustments for accounting distortions in certain circumstances for a similar reason: that is to arrive at more meaningful ratios (see paragraphs 140-167). The "nonoperating activities and nonrecurring items" section of the ratio and adjustments criteria gives examples of measurement effects and accounting distortions that we exclude from our financial measures, such as goodwill impairments or unrealized mark-to-market gains or losses on derivatives where a company has not achieved the requirements of technical hedge accounting, even though an effective economic hedge may exist. Other examples of measurement effects and accounting distortions that we exclude from our financial measures include:

- A change in the measurement of a material litigation provision that leads to very significant gains or losses in the year; and
- Fair valuation gains or losses on investment properties under IFRS.

C. Adjusted debt principle

The adjusted debt principle mentions that "to the extent that a company defers payment beyond the term customary for its supply chain, we may add that amount to debt." Under what circumstances would you apply this and how would it be calculated? And how does Standard & Poor's treat reverse factoring arrangements?

If we believe that an issuer's trade payable days are well beyond the range of what would be deemed normal trade terms for the industry, and the improvement to cash flow/leverage measures that results from the stretch in trade payables is deemed to be material, then we'd make an adjustment. In the case of reverse factoring--which we define as financing initiated by a company in order to help its suppliers finance their receivables--we may make a debt adjustment for the customer, if we believe that the trade payable days are well beyond the range of what would be deemed normal trade terms for the industry (see above). However, we would not make an adjustment to debt for the supplier if the supplier has no contractual commitment to meet the customer's obligations and we are confident there is no moral recourse or reputational risk to the supplier as part of the reverse factoring program.

Do structured settlements (e.g., tax settlements and tobacco settlements) qualify as debt under the adjusted debt principle?

Yes. The adjusted debt principle says that we add to debt "incurred liabilities that provide no future offsetting operating benefit." Structured settlements of dispute, whether with commercial or governmental entities, fit this principle and are added to debt (on a discounted basis if feasible).

Under the adjusted debt principle, do you treat a redeemable minority interest as debt?

Yes, but only when the redemption is outside of the control of the issuer (i.e., the minority interest holder has a put option on the subsidiary's 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 (see paragraph 21) since the subsidiary is fully consolidated into the parent's accounts and, therefore, the benefits of ownership are accruing to the issuer.

D. Litigation

How does Standard & Poor's capture the risk associated with a large legal settlement, if not quantitatively captured as part of an adjustment to debt?

As stated in paragraphs 191 and 192 of "Corporate Methodology," we consider as part of our Comparable Ratings Analysis factors that may not be already or fully captured elsewhere in our analysis, such as this type of risk. Such factors will generally reflect less frequently observed credit characteristics, may be unique, or may reflect unpredictability or uncertain risk attributes, both positive and negative. In particular, we could assign a negative assessment for Comparable Ratings Analysis, depending on how well (or not) a company identifies, manages, and reserves for contingent risk exposures that can arise if guarantees are called, derivative contract break clauses are activated, or substantial lawsuits are lost.

Related Criteria And Research

- Corporate Methodology, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Nov. 19, 2013
- Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 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

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 Standard & Poor's Ratings Services' 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.

NSPM
As of August 2021
Dollars in Millions

	Projected Year End[1] 2021	Projected Year End[1] 2022	Projected Year End[1] 2023	Projected Year End[1] 2024
Adjusted Funds from Operations	**$1,765**	**$1,985**	**$2,131**	**$2,177**
Interest Expense				
Interest expense	**$254**	**$269**	**$285**	**$300**
Add AFUDC debt	**$13**	**$13**	**$12**	**$14**
Add interest expense adjustment	**$140**	**$139**	**$137**	**$134**
Adjusted Interest	**$407**	**$421**	**$433**	**$448**
EBITDA				
Operating income	**$879**	**$930**	**$974**	**$1,028**
Add depreciation & amortization	**$1,014**	**$1,144**	**$1,225**	**$1,288**
Add EBITDA adjustment	**$169**	**$176**	**$173**	**$172**
Adjusted EBITDA	**$2,062**	**$2,250**	**$2,373**	**$2,488**
Adjusted Debt				
Debt	**$6,748**	**$7,280**	**$7,547**	**$8,038**
Add debt adjustment	**$436**	**$386**	**$326**	**$268**
Adjusted Debt	**$7,184**	**$7,666**	**$7,873**	**$8,306**
Total Capitalization				
Short-term debt	**$0**	**$285**	**$108**	**$150**
Long-term debt	**$6,748**	**$6,996**	**$7,439**	**$7,888**
Equity	**$7,555**	**$7,951**	**$8,437**	**$8,788**
Total Capitalization	**$14,303**	**$15,231**	**$15,984**	**$16,826**

S&P's Key Metrics	CCR Guidance[2]	Projected YE 2021	Projected YE 2022	Projected YE 2023	Projected YE 2024
FFO/Debt (%)	**13-23**	**24.6**	**25.9**	**27.1**	**26.2**
Debt/EBITDA (x)	**3.5-4.5**	**3.5**	**3.4**	**3.3**	**3.3**
FFO/Interest (x)	**3-5**	**5.3**	**5.7**	**5.9**	**5.9**
EBITDA/Interest (x)	**2.75-5**	**5.1**	**5.3**	**5.5**	**5.6**
Debt/Capitalization (%)	**Not provided**	**50.2**	**50.3**	**49.3**	**49.4**

1.) The financial data for the Projected Year End 2021 - 2024 is from Treasury Forecasting Model.
2.) The ranges or guidance presented are based on (1) a company assigned "medial volatility" by S&P and (2) a company seeking an A/A- rating, which is the rating that NSPM wishes to continue to support and maintain.

NSPM
As of August 2021
Dollars in Millions

	Projected Year End[1] 2021	Projected Year End[1] 2022	Projected Year End[1] 2023	Projected Year End[1] 2024
Adjusted Cash from Operations pre Working Capital	**$1,632**	**$1,832**	**$1,993**	**$2,011**
Interest Expense				
Interest expense	**$254**	**$269**	**$285**	**$300**
Add AFUDC debt	**$13**	**$13**	**$12**	**$14**
Add interest expense adjustment	**$5**	**$5**	**$5**	**$5**
Adjusted Interest	**$272**	**$288**	**$302**	**$319**
Dividends	**$463**	**$506**	**$538**	**$566**
Debt				
Debt	**$6,748**	**$7,280**	**$7,547**	**$8,038**
Add debt adjustment	**$159**	**$159**	**$159**	**$159**
Adjusted Debt	**$6,907**	**$7,439**	**$7,706**	**$8,197**
Book Capitalization				
Book capitalization	**$17,332**	**$18,255**	**$19,022**	**$19,826**
Add debt adjustment	**$159**	**$159**	**$159**	**$159**
Adjusted Book Capitalization	**$17,491**	**$18,414**	**$19,181**	**$19,985**

Moody's Key Metrics	CCR Guidance[2]	Projected YE 2021	Projected YE 2022	Projected YE 2023	Projected YE 2024
CFO pre-WC / Debt (%)	**22-30**	**23.6**	**24.6**	**25.9**	**24.5**
CFO pre-WC + Interest / Interest (x)	**4.5-6**	**7.0**	**7.4**	**7.6**	**7.3**
CFO pre-WC - Dividends / Debt (%)	**17-25**	**16.9**	**17.8**	**18.9**	**17.6**
Debt / Book Capitalization (%)	**35-45**	**39.5**	**40.4**	**40.2**	**41.0**

1.) The financial data for the Projected Year End 2021 - 2024 is from Treasury Forecasting Model.
2.) The ranges or guidance presented are based on (1) a company assigned the "Standard Grid" threshold by Moody's and (2) a company seeking an A rating, which is the rating that NSPM wishes to continue to support and maintain.

Description	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
The 3 month eurodollar rates are basis for projected short term debt costs (4)												
IHS Global Insight: 3 Month Eurodollar Rate (Libor)	0.2676	0.2904	0.3016	0.3134	0.3360	0.3477	0.3970	0.5843	0.7394	0.7850	0.9621	1.0281
Bloomberg Forward Curve: 3 Month Libor	0.2600	0.3000	0.3600	0.4100	0.5600	0.6300	0.7500	0.8400				
Average 3 Month Libor Rate	0.2638	0.2952	0.3308	0.3617	0.4480	0.4889	0.5735	0.7122	0.7394	0.7850	0.9621	1.0281
Spread to Calculate NSPM's STD Rate	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647	-0.0647
Total Forecasted Short Term Debt Interest Rate	0.1991	0.2305	0.2661	0.2970	0.3833	0.4242	0.5088	0.6475	0.6747	0.7203	0.8974	0.9634
The 10 and 30-year yields on U.S. Treasuries are the basis for new long term debt (4)												
IHS Global Insight: Yield on 10-Year Treasury Notes (1)	1.7454	1.8457	1.9408	2.0230	2.1093	2.1494	2.1755	2.2171	2.2777	2.3479	2.4226	2.4907
Credit Spread	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000
Total Forecasted LTD Coupon Interest Rate	2.2454	2.3457	2.4408	2.5230	2.6093	2.6494	2.6755	2.7171	2.7777	2.8479	2.9226	2.9907
Bloomberg Forward Curve: Yield on 10-Year Treasury Notes (2) (3)	1.8800	1.9600	2.0000	2.0900	2.1600	2.2700	2.3300					
Credit Spread	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000	0.5000					
Total Forecasted LTD Coupon Interest Rate	2.3800	2.4600	2.5000	2.5900	2.6600	2.7700	2.8300					
Average: Total Forecasted LTD Coupon Interest Rate on 10-year Treasury Notes	2.4000	2.5000	2.5000	2.6000	2.7000	2.8000	2.8000	2.8000	2.8000	2.9000	3.0000	3.0000
IHS Global Insight: Yield on 30-Year Treasury Notes (1)	2.3486	2.4519	2.5470	2.6274	2.7092	2.7456	2.7672	2.7987	2.8454	2.8997	2.9576	3.0102
Credit Spread	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000
Total Forecasted LTD Coupon Interest Rate	3.0486	3.1519	3.2470	3.3274	3.4092	3.4456	3.4672	3.4987	3.5454	3.5997	3.6576	3.7102
Bloomberg Forward Curve: Yield on 30-Year Treasury Notes (2) (3)	2.5100	2.5800	2.6200	2.7000	2.7800	2.8800	2.9400					
Credit Spread	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000	0.7000					
Total Forecasted LTD Coupon Interest Rate	3.2100	3.2800	3.3200	3.4000	3.4800	3.5800	3.6400					
Average: Total Forecasted LTD Coupon Interest Rate on 30-year Treasury Notes	3.2000	3.3000	3.3000	3.4000	3.5000	3.6000	3.6000	3.5000	3.6000	3.6000	3.7000	3.8000

(1) Source: IHS Global Insight, July 2021.
(2) Source: Bloomberg Forward Curve, July 2021.
(3) Bloomberg forecasts interest rates for only two future years; therefore, Q4 2023 and 2024 amounts were unavailable as of the date of the long-term interest rate calculation.
(4) The 2022-2024 data is based on available interest rate forecast data as of Q2 2021 and are inherently subject to change.

TEST YEAR - 2022 FORECASTED SHORT TERM DEBT AND COST

		Cost of Short Term Debt			
	Month End Balances	Average Of Month End Balances (1)	Monthly Interest Expense (2)	Monthly Fees Expense (3)	Average Short Term Debt Cost
2022 Jan	$0	$0	$0	$43,506	
2022 Feb	$0	$0	$0	$39,416	
2022 Mar	$0	$0	$0	$43,506	
2022 Apr	$0	$0	$0	$42,143	
2022 May	$0	$0	$0	$43,506	
2022 June	$0	$0	$0	$42,143	
2022 Jul	$115,849,417	$57,924,708	$13,275	$43,506	
2022 Aug	$102,201,848	$109,025,632	$24,985	$43,506	
2022 Sep	$121,138,284	$111,670,066	$24,766	$42,143	
2022 Oct	$254,772,447	$187,955,366	$48,074	$43,506	
2022 Nov	$254,275,945	$254,524,196	$63,001	$42,143	
2022 Dec	$218,346,020	$236,310,983	$60,443	$43,506	
Average	$88,881,997	$79,784,246			
Total			$ 234,544	$ 512,527	
			0.29%	0.64%	0.94%

(1) January through December Average of Month End Balances.

(2) Monthly Interest Expense is based on the weighted average of short term debt outstanding and Interest Rates are based on the Global Insights and Bloomberg Forecast.

(3) Ongoing fees for NSP-MN's five-year credit facility that was re-syndicated on June 7, 2019. This expense represents the monthly cost of NSP-MN unused portion of the credit facility. Credit facility is used primarily as back up for commercial paper and letters of credit. (Upfront expenses for the five year credit facility are amortized over the life of the facility and are included in the cost of long term debt.)

TEST YEAR - 2023 FORECASTED SHORT TERM DEBT AND COST

			Cost of Short Term Debt		
	Month End Balances	Average Of Month End Balances (1)	Monthly Interest Expense (2)	Monthly Fees Expense (3)	Average Short Term Debt Cost
2023 Jan	$272,842,566	$245,594,293	$81,065	$43,506	
2023 Feb	$224,514,281	$248,678,423	$74,140	$39,416	
2023 Mar	$233,732,019	$229,123,150	$75,628	$43,506	
2023 Apr	$268,228,726	$250,980,373	$88,720	$42,143	
2023 May	$0	$134,114,363	$48,989	$43,506	
2023 June	$38,375,528	$19,187,764	$6,783	$42,143	
2023 Jul	$177,608,723	$107,992,125	$47,319	$43,506	
2023 Aug	$109,005,262	$143,306,993	$62,793	$43,506	
2023 Sep	$67,377,108	$88,191,185	$37,396	$42,143	
2023 Oct	$179,429,437	$123,403,272	$68,806	$43,506	
2023 Nov	$163,773,632	$171,601,534	$92,593	$42,143	
2023 Dec	$144,209,100	$153,991,366	$85,861	$43,506	
Average	$156,591,365	$159,680,403			
Total			$ 770,093	$ 512,527	
			0.48%	0.32%	0.80%

(1) January through December Average of Month End Balances.

(2) Monthly Interest Expense is based on the weighted average of short term debt outstanding and Interest Rates are based on the Global Insights Forecast.

(3) Ongoing fees for NSP-MN's five-year credit facility that was re-syndicated on June 7, 2019. This expense represents the monthly cost of NSP-MN unused portion of the credit facility. Credit facility is used primarily as back up for commercial paper and letters of credit. (Upfront expenses for the five year credit facility are amortized over the life of the facility and are included in the cost of long term debt.)

TEST YEAR - 2024 FORECASTED SHORT TERM DEBT AND COST

		Cost of Short Term Debt			
	Month End Balances	Average Of Month End Balances (1)	Monthly Interest Expense (2)	Monthly Fees Expense (3)	Average Short Term Debt Cost
2024 Jan	$213,734,229	$178,971,665	$103,979	$43,506	
2024 Feb	$126,958,773	$170,346,501	$92,583	$39,416	
2024 Mar	$101,500,832	$114,229,803	$66,365	$43,506	
2024 Apr	$166,550,711	$134,025,772	$80,447	$42,143	
2024 May	$0	$83,275,356	$51,651	$43,506	
2024 June	$0	$0	$0	$42,143	
2024 Jul	$16,567,683	$8,283,842	$6,402	$43,506	
2024 Aug	$0	$8,283,842	$6,402	$43,506	
2024 Sep	$0	$0	$0	$42,143	
2024 Oct	$72,581,533	$36,290,767	$30,106	$43,506	
2024 Nov	$60,435,771	$66,508,652	$53,394	$42,143	
2024 Dec	$60,819,712	$60,627,742	$50,295	$43,506	
Average	$68,262,437	$71,736,995			
Total			$ 541,624	$ 512,527	
			0.76%	0.71%	1.47%

(1) January through December Average of Month End Balances.

(2) Monthly Interest Expense is based on the weighted average of short term debt outstanding and Interest Rates are based on the Global Insights Forecast.

(3) Ongoing fees for NSP-MN's five-year credit facility that was re-syndicated on June 7, 2019. This expense represents the monthly cost of NSP-MN unused portion of the credit facility. Credit facility is used primarily as back up for commercial paper and letters of credit. (Upfront expenses for the five year credit facility are amortized over the life of the facility and are included in the cost of long term debt.)

NSPM Utility Money Pool Activity
Summary - January 2019 through June 2021

	Borrowings			Investments		
Date	Average Amount Outstanding	Actual Interest Rate	Alternative Interest Rate *	Average Amount Outstanding	Actual Interest Rate	Alternative Interest Rate **
2019						
Jan	$ -	2.5000%	5.5000%			
Feb	$ -	2.4500%	5.5000%			
Mar	$ 2,032,258	2.4400%	5.5000%	$ 3,677,419	2.4400%	1.6500%
Apr	$ -	2.4600%	5.5000%	$ 26,833,333	2.4600%	1.6500%
May	$ 580,645	2.4200%	5.5000%	$ 12,838,710	2.4200%	1.6500%
Jun	$ 6,666,667	2.4100%	5.5000%			
Jul	$ 50,000,000	2.3200%	5.5000%			
Aug	$ 152,516,129	2.2000%	5.2500%			
Sep	$ 70,766,667	2.0300%	5.1250%			
Oct	$ 1,967,742	1.9300%	5.0000%			
Nov	$ 32,200,000	1.7300%	4.7500%			
Dec	$ 66,838,710	1.6300%	4.7500%			
2020						
Jan	$ 29,516,129	1.5800%	4.7500%	$ 1,903,226	1.5800%	1.3500%
Feb	$ -	1.5600%	4.7500%	$ 30,000,000	1.5600%	1.3500%
Mar	$ -	1.1500%	3.7500%	$ 61,032,258	1.1500%	0.7550%
Apr	$ -	1.4200%	3.2500%	$ 24,966,667	1.4200%	0.1600%
May	$ -	0.1900%	3.2500%	$ 21,419,355	0.1900%	0.1600%
Jun	$ -	0.1400%	3.2500%	$ 533,333	0.1400%	0.1600%
Jul	$ -	0.0000%	3.2500%			
Aug	$ -	0.0000%	3.2500%			
Sep	$ -	0.0900%	3.2500%	$ 12,066,667	0.0900%	0.0500%
Oct	$ 1,032,258	0.0800%	3.2500%	$ 25,903,226	0.0800%	0.0500%
Nov	$ -	0.1000%	3.2500%	$ 65,633,333	0.1000%	0.0500%
Dec	$ -	0.0700%	3.2500%	$ 51,967,742	0.0700%	0.0500%
2021						
Jan	$ 21,709,677	0.0900%	3.2500%			
Feb	$ 9,000,000	0.0700%	3.2500%			
Mar	$ 40,774,193	0.0600%	3.2500%			
Apr	$ -	0.0700%	3.2500%			
May	$ -	0.0400%	3.2500%	$ 14,290,322	0.0400%	0.0200%
Jun	$ -	0.0200%	3.2500%	$ 40,833,333	0.0200%	0.0200%

* Based on the Fed Prime Rate.
** From the bank sweep account. Overnight sweep accounts are standard in the treasury management field and are designed to provide investment options for earning a return on funds that would otherwise be sitting idle in a non-interest bearing checking account.

TEST YEAR - 2022 FORECASTED EQUITY BALANCES

Month	GAAP Common Equity Outstanding	Non-Regulated Subsidiaries (1)	Regulated Common Equity
2021 Dec	$7,578,635	$926	$7,577,709
2022 Jan	$7,600,675	$926	$7,599,749
2022 Feb	$7,642,777	$926	$7,641,851
2022 Mar	$7,581,670	$926	$7,580,744
2022 Apr	$7,611,714	$926	$7,610,788
2022 May	$7,641,719	$926	$7,640,793
2022 Jun	$7,598,169	$926	$7,597,243
2022 Jul	$7,688,956	$926	$7,688,030
2022 Aug	$7,774,285	$926	$7,773,359
2022 Sep	$7,715,856	$926	$7,714,930
2022 Oct	$7,805,862	$926	$7,804,936
2022 Nov	$7,876,967	$926	$7,876,041
2022 Dec	$7,932,382	$926	$7,931,456
13 Month Average	$7,696,128	$926	$7,695,202

(1) United Power and Land.

TEST YEAR - 2023 FORECASTED EQUITY BALANCES

Month	GAAP Common Equity Outstanding	Non-Regulated Subsidiaries (1)	Regulated Common Equity
2022 Dec	$7,932,382	$926	$7,931,456
2023 Jan	$8,081,374	$926	$8,080,448
2023 Feb	$8,131,782	$926	$8,130,856
2023 Mar	$8,064,256	$926	$8,063,330
2023 Apr	$8,146,453	$926	$8,145,527
2023 May	$8,179,115	$926	$8,178,189
2023 Jun	$8,122,688	$926	$8,121,762
2023 Jul	$8,220,396	$926	$8,219,470
2023 Aug	$8,312,071	$926	$8,311,145
2023 Sep	$8,246,521	$926	$8,245,595
2023 Oct	$8,323,078	$926	$8,322,152
2023 Nov	$8,381,140	$926	$8,380,214
2023 Dec	$8,342,558	$926	$8,341,632
13 Month Average	$8,191,063	$926	$8,190,137

(1) United Power and Land.

TEST YEAR - 2024 FORECASTED EQUITY BALANCES

Month	GAAP Common Equity Outstanding	Non-Regulated Subsidiaries (1)	Regulated Common Equity
2023 Dec	$8,342,558	$926	$8,341,632
2024 Jan	$8,477,227	$926	$8,476,301
2024 Feb	$8,547,210	$926	$8,546,284
2024 Mar	$8,481,050	$926	$8,480,124
2024 Apr	$8,533,863	$926	$8,532,937
2024 May	$8,569,484	$926	$8,568,558
2024 Jun	$8,507,166	$926	$8,506,240
2024 Jul	$8,612,711	$926	$8,611,785
2024 Aug	$8,708,575	$926	$8,707,649
2024 Sep	$8,630,028	$926	$8,629,102
2024 Oct	$8,710,807	$926	$8,709,881
2024 Nov	$8,801,646	$926	$8,800,720
2024 Dec	$8,749,414	$926	$8,748,488
13 Month Average	$8,590,134	$926	$8,589,208

(1) United Power and Land.

Date	Issuing Company	Shares Issued	Market Price	Offering Price	Underwriting Discount	Offering Expense	Net Proceeds	Total Flotation Costs	Gross Equity Issue before Costs	Net Proceeds	Flotation Cost Percentage
11/16/1949	Northern States Power	1,584,238	$10.750	$10.250	$0.124	$0.137	$9.989	$1,205,605	$17,030,559	$15,824,953	7.079%
6/4/1952	Northern States Power	1,108,966	$10.500	$10.500	$0.098	$0.162	$10.240	$288,331	$11,644,143	$11,355,812	2.476%
4/14/1954	Northern States Power	1,219,856	$15.250	$14.000	$0.060	$0.124	$13.816	$1,749,274	$18,602,804	$16,853,530	9.403%
2/29/1956	Northern States Power	670,920	$17.825	$16.750	$0.050	$0.221	$16.479	$903,058	$11,959,149	$11,056,091	7.551%
7/22/1959	Northern States Power	952,033	$23.375	$22.000	$0.069	$0.191	$21.740	$1,556,574	$22,253,771	$20,697,197	6.995%
7/28/1965	Northern States Power	772,008	$35.250	$33.000	$0.092	$0.225	$32.683	$1,981,745	$27,213,282	$25,231,537	7.282%
1/22/1969	Northern States Power	1,080,811	$29.000	$27.000	$0.119	$0.187	$26.694	$2,492,350	$31,343,519	$28,851,169	7.952%
10/21/1970	Northern States Power	1,729,298	$23.125	$21.500	$0.175	$0.149	$21.176	$3,370,402	$39,990,016	$36,619,614	8.428%
7/26/1972	Northern States Power	1,902,228	$25.000	$23.500	$0.129	$0.166	$23.205	$3,414,499	$47,555,700	$44,141,201	7.180%
10/10/1973	Northern States Power	2,092,451	$25.825	$24.500	$0.128	$0.153	$24.219	$3,360,476	$54,037,547	$50,677,071	6.219%
11/20/1974	Northern States Power	2,300,000	$17.625	$17.500	$0.910	$0.069	$16.521	$2,539,200	$40,537,500	$37,998,300	6.264%
8/14/1975	Northern States Power	1,750,000	$23.000	$23.000	$0.740	$0.077	$22.183	$1,429,750	$40,250,000	$38,820,250	3.552%
6/3/1976	Northern States Power	2,000,000	$24.000	$24.000	$0.720	$0.064	$23.216	$1,568,000	$48,000,000	$46,432,000	3.267%
5/31/1993	Northern States Power	3,041,955	$44.125	$43.625	$1.200	$0.048	$42.377	$5,317,337	$134,226,264	$128,908,927	3.961%
9/23/1997	Northern States Power	4,500,000	$49.938	$49.563	$1.230	$0.133	$48.200	$7,821,000	$224,721,000	$216,900,000	3.480%
9/29/1997	Northern States Power	400,000	$50.500	$49.563	$1.230	$0.133	$48.200	$920,000	$20,200,000	$19,280,000	4.554%
2/25/2002	Xcel Energy, Inc.	20,000,000	$22.950	$22.500	$0.730	$0.015	$21.755	$23,900,000	$459,000,000	$435,100,000	5.207%
9/9/2008	Xcel Energy, Inc.	17,250,000	$20.860	$20.200	$0.100	$0.006	$20.094	$13,218,352	$359,835,000	$346,616,648	3.673%
8/3/2010	Xcel Energy, Inc.	21,850,000	$22.100	$21.500	$0.645	$0.013	$20.571	$33,407,927	$482,885,000	$449,477,073	6.918%
March 2013	Xcel Energy, Inc.	7,757,449	$29.057	$29.057	$0.291	$0.052	$28.714	$2,657,558	$225,407,642	$222,750,085	1.179%
June 2014	Xcel Energy, Inc.	5,693,946	$30.663	$30.663	$0.307	$0.030	$30.326	$1,915,210	$174,592,340	$172,677,130	1.097%
September 2018	Xcel Energy, Inc.	4,733,435	$47.885	$47.885	$0.407	$0.073	$47.405	$2,271,040	$226,661,287	$224,390,247	1.002%
8/29/2019	Xcel Energy, Inc.	9,359,103	$48.416	$48.416	$0.161	$0.041	$48.215	$1,886,029	$453,132,797	$451,246,767	0.416%
11/30/2020	Xcel Energy, Inc.	11,845,000	$60.865	$60.865	$0.665	$0.025	$60.175	$8,168,737	$720,941,187	$712,772,450	1.133%
	Total Public Issuances							$127,342,454	$3,892,020,508	$3,764,678,054	3.272%
	Total Non-Public Issuances							$0	$1,724,487,000	$1,724,487,000	0.000%
NSP/NCE Merger[1]		N/A	N/A	N/A	N/A	N/A	N/A	N/A	$1,944,007,000	N/A	
NRG stock for stock exchange									$1,077,456,000		
Total									$6,913,483,508		

[1] Additional paid in capital for NSP/NCE Merger = $1,944,007,000
Additional paid in capital for NRG = $1,077,456,000
These are balance sheet adjustments to additional paid in capital which did not incur any flotation costs.