Article Title: ARCHIVE | Criteria | Corporates | General: CreditStats: Standard & Poor's Revises Statistical Practices Data: Last year, Standard & Poor's Ratings Services reviewed and revised its calculations of issuers' financial statistics for both internal and external users to ensure that these measures were reported with the greatest consistency possible across regions and industries. An important enabler of this ongoing effort has been the steady progress made toward adopting uniform global accounting standards. The increasingly broad adoption of International Financial Reporting Standards (IFRS) sharply reduces the need for country- or region-specific financial analysis tools, thereby improving consistency and cross-region comparability of issuers' financial statistics. With the widespread adoption on Jan. 1, 2005, of IFRS in Europe, the review and comparison of North American and European financial analysis practices became a logical starting point. Our review indicated that there were several areas of minor inconsistency and ample opportunity to simplify our reports. These changes are being implemented and will appear shortly in all our published reports, including CreditStats, on corporate issuers in Europe and North America. Please note: The figures in these new reports will likely show many differences from previously published figures. Because these differences are not the result of criteria changes per se, but refinements to existing methodologies, no ratings will be changed solely due to these revisions. Significant Changes In Presentation, Treatment Of Preferred Stock, Other Measures Presentation will be uniform In some cases, Standard & Poor's had presented analyses using two sets of measures based on different assumptions or treatments, with the inference that "reality" lay somewhere in between these two sets. Although a valid analytical approach, this presentation often confused issuers and investors. Accordingly, after a short transition period, all credit measures will be presented one way: with all appropriate adjustments. Intermediate equity content hybrids (preferred stock) will be split between debt and equity The most significant effect of the decision to simplify the presentation of credit measures will be on the treatment of intermediate equity content hybrids in our financial analysis. The former presentation of these instruments in one set of ratios as debt and in another set as equity has been superseded. Across the statements, these instruments will now be divided 50%/50% into debt and equity, and their associated periodic payments will be divided equally into interest and dividends (see the media release titled, "Standard & Poor's Changes Ratio Calculations For Hybrid Securities In Corporates," published May 8, 2006," on RatingsDirect, Standard & Poor's Web-based research and credit analysis system). Adjustments made for operating leases In the past, we factored in operating leases as financial obligations in one of two ways: by taking the net present value (NPV) of future minimum commitments, or by approximating the obligation by using a multiple of the last annual rental expense. The use of these substantially differing approaches was driven by reporting differences. Although components of the NPV approach were mandatory U.S. GAAP disclosures, few other accounting regimens required such disclosures. Now, IFRS requires disclosing at least the following period's minimum commitment, the sum of the commitments for the next four years, and the total of subsequent commitments. Given the more similar reporting, a more fully harmonized adjustment is possible and has been adopted. The "factor method" has now been discontinued as part of our systematic/standard adjustments in favor of our long-standing NPV method (see "Corporate Ratings Criteria--Operating Lease Analytics," published June 9, 2005). Funds from operations (FFO) to total debt will now be measured uniformly at year-end For utilities issuers, our former practice was to use the average of the latest year's and previous year's total debt in the denominator, while we used year-end total debt for issuers in the rest of Industrials. Given that a credit rating is an opinion about a company's ability to generate cash to meet its obligations, this ratio is an important measure of that ability. In this context, using the latest data provides a more forward-looking view and is preferred. Net debt adjustment will be simplified and harmonized This adjustment is used mainly for U.S. pharmaceutical companies and a wide range of European firms. The methodology used for U.S. pharmaceutical companies was developed and refined for their particular circumstances-–the build-up of cash and investments in tax-advantaged locations with associated tax penalties for "repatriating" these funds to the U.S. The European methodology was simpler-–subtract all available cash balances from debt-–and was widely applied in European investment-grade credits. Both of these approaches have been abandoned in favor of a new approach in which the analyst will need to make a specific, justifiable determination of the availability of funds to repay debt. Elements to consider will include the U.S.-specific issues noted above, as well as the nature of the investments and the need for a company to maintain some cash to operate efficiently. The borrower's direct control over, the immediate availability of, and the currency of funds will remain important considerations. In addition, the netting of investment income from interest expense has been abandoned. In practice, this netting tended to generate interest coverage measures that were extremely high and not meaningful; also, disclosure requirements on financial income remain fairly loose. EBIT interest coverage will not change The existing definition of EBIT to include all recurring operating and nonoperating expenses was re-affirmed. Interest expense includes capitalized interest but, as noted above, does not subtract any interest income. Net income and related ratios are "as reported" Many of the adjustments we make to a company's figures could affect net income, but implementing these adjustments would diminish its usefulness in monitoring a key driver of management behavior. The same reasoning applies to the investor-oriented measures of common dividend payout and return on common equity, which are based on unadjusted components. Post-Retirement Benefit (PRB) Changes Equity will consider both net deficits and surpluses PRB-adjusted equity now includes the tax-affected funded status (plan assets less plan obligations), whether it is a net deficit or net surplus. Previously, only net deficits were included in the adjustment. Surpluses reported by the company as being "irrecoverable" in the accounting disclosures, for example under IFRS or U.K. GAAP, will be kept as assets for the sake of numerical simplicity. Disclosure of such amounts will not be available for many companies. Income adjustment will not change, but guidance is clarified The existing adjustment to income has been re-affirmed. However, our review indicated that we needed to clarify the guidance. Only current service cost is considered in operating income and charges. The adjustment will remove amounts related to curtailments, settlements, special termination benefits, amortization of unrecognized gains and losses, and previous/past service costs. This current service cost should exclude the portion effectively covered by employee contributions. The PRB adjustment to interest expense will now be capped at zero in all cases, i.e., returns on plan assets that are in excess of PRB interest can be adjusted three ways and used to reduce interest on debt and other financial obligations. FFO will include service, interest costs and return on plan assets PRB-adjusted FFO will include, on a tax-affected basis, the total of service cost, interest cost, and return on plan assets. The return on plan assets used can now be based on actual returns or normalized returns. Normalized returns can be an analyst-selected rate of return or the company's expected return. Cash payments in excess of this return are considered to be debt repayment, and cash payments below this return are considered to be borrowing. Additional Changes Possible As this effort expands to cover more regions, it is possible that additional refinements will be developed. Standard & Poor's is committed to communicating these changes, if any, as quickly as possible. We are also exploring various tools to better communicate the details of these adjustments so a reader can trace the development of a company's adjusted ratios from its reported financial data. These endeavors are part of our continuing commitment to improve the transparency of our rating processes.