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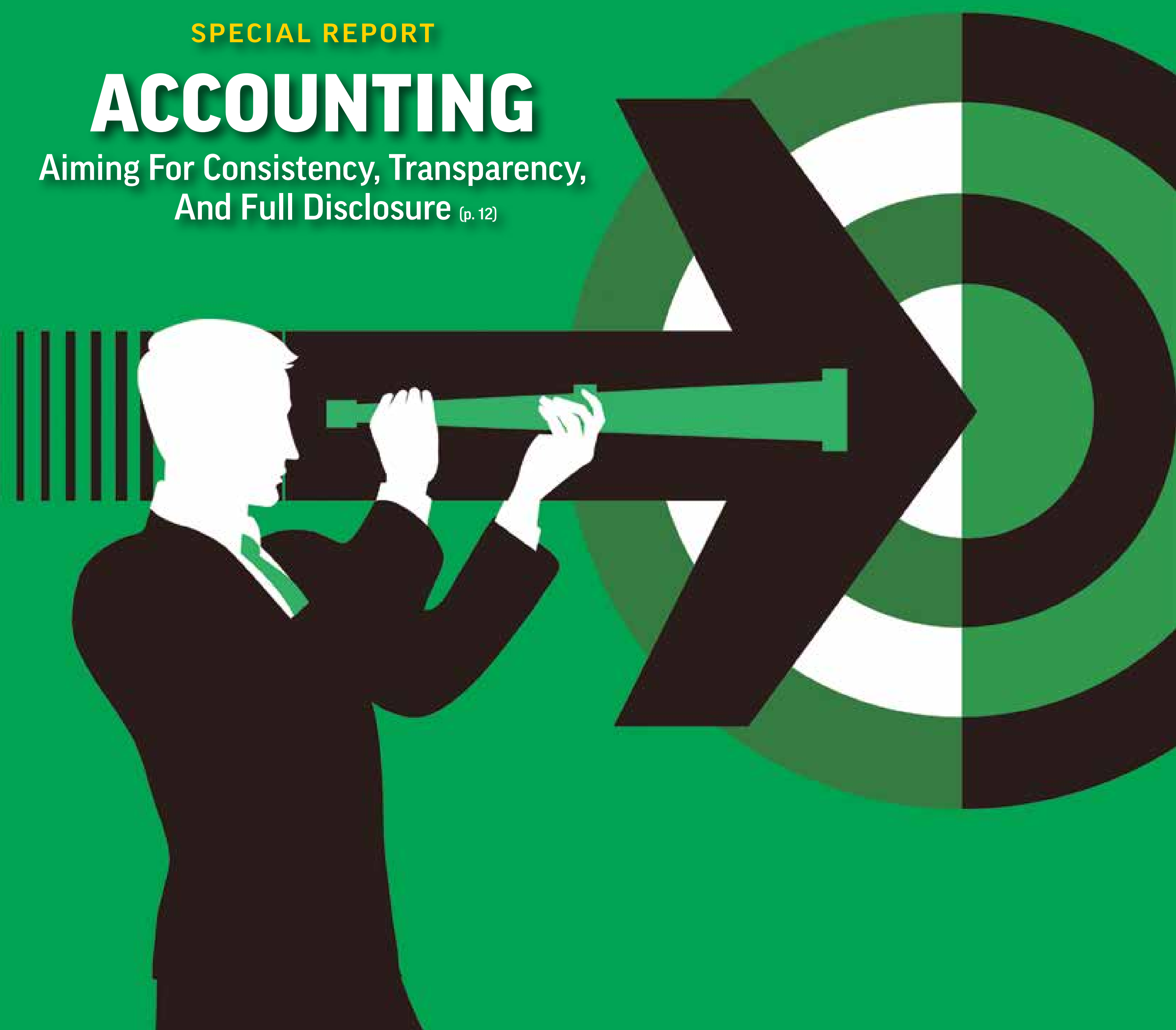
# CreditWeek®

The Global Authority On Credit Quality | February 26, 2014

SPECIAL REPORT

## ACCOUNTING

Aiming For Consistency, Transparency, And Full Disclosure (p. 12)



# EDITOR'S DESK

Through U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS), the accounting profession seeks to reflect, accurately, clearly, and fairly, businesses' financial results and condition. But, according to our credit analysts, this state of affairs is some way off. In our special report this week, we enter the labyrinth of global financial reporting standards to see what progress has been made and what remains to be done.

Credit analyst Joyce Joseph says, "The reports upon which global financial statement users depend are an amalgam of accounting standards, regulatory mandates, and management discretion, which can result in an unpredictable mix of information—or lack thereof—that makes analyzing financial statements more complicated than we believe necessary."

One of the key measures investors rely upon is EBITDA (earnings before interest, taxes, depreciation, and amortization). Despite its importance in financial analysis, credit analyst Mark Solak observes, "EBITDA may exclude a number of costs and cash flows and, therefore, can sometimes paint an overly rosy picture of a company's performance." For our ratings analysis, he stresses, we don't rely upon an entity's figures and instead calculate EBITDA according to our own standard definition. "Our ratings are relative, and achieving comparability in the metrics we use to evaluate companies is critical to arriving at our assessment of relative creditworthiness," he says.

How companies report their statements of cash flows presents a serious challenge to comparability, with no two being alike. But, as Mr. Solak asserts, "There are ways to improve the transparency and comparability of the statement of cash flows to better enable financial statement analysis." Part of the problem lies with accounting's governing bodies, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). In 2011, they shelved a joint project to standardize organization and presentation of financials, including cash flow statements.

Also in this issue are articles covering reporting of exceptional items at nonfinancial FTSE 100 companies, non-GAAP measures, U.S. bank disclosures, and investor concerns about proposed accounting rules for financial services companies.

Marguerite Nugent

**Marguerite Nugent**
*Managing Editor*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**47 Analytical Dilemmas When Using Non-GAAP Measures In The U.S. Insurance Sector**

**By David B. Chan, CPA, New York**

U.S. generally accepted accounting principles provide a common accounting framework for companies to disclose financial results and measures. However, a company may adjust its GAAP measures to better capture and communicate certain elements of its financial performance to investors and other financial statement users. While non-GAAP measures can offer insight into an individual company's results, they often aren't easily comparable.

**52 U.S. Banks' Disclosures Have Grown, But Many Financial Risks Remain Opaque**

**By Jonathan Nus, CPA, New York**

With the annual financial reporting season in full swing, financial institution investors' attention likely will turn to the reams of disclosures banks provide to help inform them of the risks involved with investments. To increase credibility after the financial crisis, many banks have gone to considerable lengths to disclose more information about their myriad financial risks.

CREDIT FAQ

**59 Why U.S. Financial Services Investors Are Concerned That Proposed Accounting Rules Will Impede Decision Making**

**By Joyce T. Joseph, CPA, New York**

Financial statement users' views about the quality and relevance of accounting and financial reporting vary between investors and credit analysts. The spectrum of views may include the belief that accounting has unnecessarily grown increasingly complex and the application of accounting standards and related disclosure requirements remains inconsistent.

## CREDIT SPOTLIGHT



## RATINGS TRENDS



## SEMINARS

| Topic | Date | Location |
|---|---|---|
| 2014 Leveraged Finance And Recovery Hot Topics Conference | March 7, 2014 | New York |
| Standard & Poor's Ratings Services 30th Annual Insurance Conference | June 3-5, 2014 | New York |

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| Topic | Date | Location |
|---|---|---|
| Principles of Structured Finance | TBD | New York |

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## Islamic Finance Could Make Inroads Into North Africa

After tremendous global success over the past decade, with total assets estimated at about $1.4 trillion, Islamic finance could develop in North Africa, said Standard & Poor's Ratings Services in a report titled *"Islamic Finance Could Make Inroads Into North Africa,"* published Feb. 18, 2014, on RatingsDirect.

Large current account deficits and declining conventional financing sources have prompted governments from Arab spring countries to look at opportunities offered by Islamic finance.

"Sharia-compliant banking previously presented an attractiveness that was at best exotic for regulators and banks active in these markets. Now, the perception is changing and public awareness is increasing," said credit analyst Mohamed Damak.

We have observed this development in the North African countries where we rate banks—Egypt, Tunisia, and Morocco. These sovereigns have recently taken steps to implement policies to support the development of Islamic finance: Tunisia plans to issue sukuk to attract a new class of investors; Egypt implemented new regulatory frameworks for sukuk issuance; and Morocco is laying the legal foundation for Islamic banks.

Nevertheless, we believe that Islamic finance in this region has yet to demonstrate its economic added value beyond enabling products abiding with Islamic law. Such added value could materialize through creating access to a new class of investors or by offering Sharia-compliant products at costs comparable with their conventional counterparts. The stiff price competition in some of the North African markets indicates that customers in these regions are relatively more sensitive to the costs associated with banking products.

"Islamic finance in North Africa remains underdeveloped but regulatory changes are laying the groundwork for its growth," said Mr. Damak. "However, we believe that success will depend on their ability to offer products at a cost competitive with conventional banking activities."

We also believe that Islamic finance can be a good fit for infrastructure and project finance, as banks lack long-term funding capability required by these projects. Several projects in renewable energy, transport infrastructure, and communication are ongoing or expected to be launched in the future in North African countries. Using sukuk to finance some of these projects could help diversify investor bases and tap additional pools of resources.

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## Brazil's Banks And Insurers Profit From Bancassurance In A Sluggish Economy

The bancassurance model is gaining prominence in developing markets such as Latin America, where insurers see it as one of the best ways to reach the region's emerging middle-class, according to a Standard & Poor's report titled *"Brazil's Banks And Insurers Profit From Bancassurance In A Sluggish Economy,"* published Feb. 17, 2014, on RatingsDirect.

"Bancassurance has proven especially potent in Brazil, where it has been booming along with the overall insurance market for the past decade," said credit analyst Amalia Bulacios. Since the 2009 financial crisis, financial groups in Brazil have looked to add more fee- and commission-based businesses, and the bancassurance model has proven itself. Although Brazil's banks and financial groups have been getting a bigger share of their revenues from the insurance business each year, the penetration of insurance sales among bank clients in Brazil is still very low, probably below 30% according to our estimates. That means that there is still room to grow.

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# Standard & Poor's Responds To IASB's Discussion Paper On Its Conceptual Framework For Financial Reporting

Standard & Poor's published its response to the International Accounting Standards Board (IASB) Discussion Paper *"A Review of the Conceptual Framework for Financial Reporting (DP/2013/1)."* (For the full response, see *"Proposed Framework For IFRS Could Improve Disclosures And Comparability,"* published Feb. 17, 2014, on RatingsDirect.)

In our view, a robust and comprehensive Conceptual Framework, within which accounting standards are consistent, provides a foundation for accounting and financial reporting that can accommodate existing and changing circumstances and varying economic environments. Such a framework would greatly lessen the need for frequent or wholesale revisions to accounting standards and thus promote comparability and understandability in financial reporting for investors.

We encourage the IASB to develop a joint Conceptual Framework in collaboration with the U.S. Financial

Accounting Standards Board. Because we rate companies globally, comparability in accounting and financial reporting is important to our peer and trend analysis.

We believe a comprehensive, uniformly applied disclosure framework is ever more important to analysis of financial reports and that it should be a key part of the Conceptual Framework. In our view, financial reporting disclosures currently lack completeness, consistency, and clarity of information which can impede financial analysis.

We believe a disclosure framework that promotes a tiered disclosure regime could be helpful to analysis. Such a regime could consist of three tiers of disclosure:

- A disclosure set principally composed of roll-forwards and tabular disclosures;
- Disclosures based on existing IFRS; and
- Disclosures that go beyond those set out in Tiers 1 and 2 that companies provide based on relevance and materiality, for financial statement users to properly understand the financial performance, financial position, cash flow prospects, and risks of the company.

Although we largely support the definitions of assets and liabilities proposed in the Discussion Paper, we are concerned that the proposed definitions may cause some companies to recognize items not previously recognized as assets or liabilities, while others do not. This can impede peer comparability, which is an important element of analysis. Therefore, before issuing a revised Conceptual Framework, we believe the IASB should consider whether specific Standards need to be revised to address this issue.

We strongly believe it is appropriate for information in financial statements to be neutral and free from bias. While financial statements unavoidably reflect management judgments and estimates, we believe exercising appropriate caution in judgments and estimates helps to avoid misrepresentation in financial reporting and thus enhances the relevance of financial reporting for users.

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# Spreads Buck Widening Trend Following Increased Tapering

On Jan. 29, 2014, the Federal Open Market Committee announced a $10 billion reduction in its bond buying program to $65 billion a month by cutting its monthly mortgage bond and treasury purchases by $5 billion each, said an article published Feb. 18, 2014, on RatingsDirect, by Standard & Poor's Global Fixed Income Research, titled *"Spreads Buck Widening Trend Following Increased Tapering."*

"In the two weeks since the announcement, the investment-grade composite spread narrowed by 1 basis point (bp) to 161 bps and the speculative-grade composite spread tightened by 14 bps to 436 bps," said Diane Vazza, head of Standard & Poor's Global Fixed Income Research. "In the two weeks preceding the announcement, the investment-grade and speculative-grade spreads widened by 3 bps and 23 bps, respectively."

Speculative-grade issuance decreased to $5.1 billion from $19.6 billion over the past week, and the spread contracted by 21 bps to 436 bps. The speculative-grade spread is tighter than both its one-year moving average of 483 bps and its five-year moving average of 654 bps. Investment-grade issuance decreased to $500 million from $7 billion over the past week, and the spread narrowed by 3 bps to 161 bps. The investment-grade spread is tighter than both its one-year moving average of 179 bps and its five-year moving average of 213 bps.

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## Turkish Banks' Asset Quality Is Vulnerable To An Economic Downturn, Despite Credit Strengths

Economic pressures could start to weigh on Turkish banks' asset quality, said Standard & Poor's in a report published Feb. 17, 2014, on RatingsDirect, titled *"Turkish Banks' Asset Quality Is Vulnerable To An Economic Downturn, Despite Credit Strengths."*

"We believe heightened domestic political risk, repercussions of tapering of the U.S. Federal Reserve's quantitative easing, and a slowdown in Turkey's economic growth are prompting a deterioration in the operating environment for Turkish banks," said credit analyst Magar Kouyoumdjian.

Turkish banks have demonstrated steadily improving financial profiles since undertaking decisive structural reforms following the country's economic and financial crisis of 2001. Since 2010, they have experienced among the fastest rates in credit growth compared with most countries. Over the past four years, domestic credit stock as a percentage of GDP has increased by more than 20 percentage points, approaching 60% of GDP. Growth in lending to consumers and small and mid-size enterprises has fueled credit growth.

While we expect this growth to continue, albeit at a slower pace, we believe that Turkish banks are now more exposed to an economic slowdown than ever.

Rapid depreciation of the Turkish lira since mid-2013 is testing the resilience of banks' foreign exchange lending and will continue to do so in 2014, in our opinion.

Furthermore, accelerated growth in commercial real estate has potential to cause a bubble.

Similar conditions in other countries in the region—such as Romania, Hungary, Serbia, and Bulgaria—led to a surge of nonperforming assets in their financial sectors, stunting growth for half a decade. We nevertheless see some fundamental differences in Turkey that should prevent such destabilizing shocks.

"Our current base-case scenario for the Turkish banking sector incorporates a moderate economic slowdown with real GDP growth averaging 2.2% during 2014-2015. We would expect asset quality to deteriorate only marginally and affect banks' profitability moderately," said Mr. Kouyoumdjian. "This would not materially affect banks' overall financial profiles, particularly given the good interest margins and capitalization. Moreover, asset quality metrics still look relatively strong, and proactive measures taken by the banking regulator, the BDDK, have helped cushion the blow on asset quality."

Aside from this report on the vulnerability of Turkish banks' asset quality, we also highlighted the growing risks in banks' funding and liquidity in the article titled *"Loan Growth And Low Domestic Savings Are Stretching Turkish Banks' Funding Profiles,"* published Dec. 5, 2012.

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## Del Monte Corp. 'B' Rating Unchanged On Expected Divestiture; Term Loan Ratings Raised On Anticipated Debt Paydown

Standard & Poor's affirmed its 'B' corporate credit rating on U.S.-based Del Monte Corp. At the same time, we raised the issue-level rating on the company's term loan B to 'B+' from 'B'. The recovery rating was revised to '2' from '3', indicating that lenders could expect substantial (70% to 90%) recovery in the event of a payment default. The higher recovery rating reflects the company's anticipated paydown in senior secured debt, providing additional recovery value for secured lenders.

The issue level rating on the company's senior unsecured notes remains 'CCC+', with a recovery rating of '6', indicating that unsecured note holders could expect negligible (0% to 10%) recovery in the event of a payment default.

"The rating actions reflect our view of the company's solid market shares, diverse product portfolio, and portfolio of well-known brands," said credit analyst Jeffrey Burian.

The ratings are based on preliminary terms and are subject to final review upon receipt of final documentation and completion of the anticipated transactions.

On Oct. 27, 2013, Del Monte Corp. had approximately $4.1 billion of total debt outstanding. Pro forma for the company's anticipated debt reduction, we estimate the company's debt outstanding will be $2.6 billion.

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## The Cash Store Financial Services Downgraded To 'CCC' On Regulators' Refusal To Issue License

Standard & Poor's lowered its issuer credit rating on Edmonton, Alta.-based The Cash Store Financial Services Inc. (CSF) to 'CCC' from 'CCC+'. The outlook is negative. At the same time, Standard & Poor's lowered its rating on CSF's senior secured notes to 'CCC' from 'CCC+'. The '4' recovery rating on the senior secured notes, which indicates our expectation for average (30% to 50%) recovery of principal if a default occurs, is unchanged.

The downgrade follows the Ontario Superior Court of Justice's order that CSF is prohibited from acting as a loan broker for its basic line

of credit product without a brokers license under the Payday Loans Act, 2008. On Feb. 13, the Registrar of the Ministry of Consumer Services in Ontario issued a proposal to refuse to issue the license. CSF announced that it has stopped offering the line of credit product in its Ontario branches.

"Although CSF intends to request a hearing before the License Appeal Tribunal, we believe that this may be a lengthy process and the outcome is highly uncertain," said credit analyst Michael Leizerovich. "In our view, it is unlikely that CSF will be able to fully replace its lost cash flows from the discontinued line of credit product. CSF currently operates approximately one-third of its total stores in Ontario, and its line of credit product represents a significant portion of its earnings in the province."

The negative outlook reflects our view that CSF's inability to offer a line of credit product in Ontario will lead to lower cash flow, which will likely result in liquidity constraints. We could lower the rating if CSF's liquidity position deteriorates to the point where we would expect that the company would not meet its interest payment obligation on its senior secured notes. We could revise the outlook to stable or raise the rating if the company generates positive cash flow and earnings for two or more consecutive quarters, and if its liquidity position stabilizes.

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## U.K.-Based Cabot Financial Downgraded To 'B' On Acquisition Of Marlin Financial Group; Outlook Stable

Standard & Poor's lowered its long-term counterparty credit rating on U.K.-based finance company, Cabot Financial Ltd. (Cabot), to 'B' from 'BB-'. The outlook is stable. We also lowered the issue ratings on the £265 million and £100 million senior secured term notes issued by Cabot's wholly owned subsidiary, Cabot Financial (Luxembourg) S.A., to 'B+' from 'BB'. The recovery rating on these notes is unchanged at '2', indicating our expectation of substantial (70% to 90%) recovery in the event of a payment default.

The downgrade reflects our view that the announced acquisition materially increases leverage and reduces debt-servicing capacity at Cabot to levels that we consider are more commensurate with a 'B' rating. Furthermore, we believe the transaction indicates an even more aggressive financial policy than we expected following the change of Cabot's ownership in mid-2013. We note Cabot's good operating performance to date, and its sound medium-term growth prospects in the U.K. distressed-debt purchase market as it consolidates its leadership position in the industry.

On Feb. 10, 2014, U.K.-based distressed-consumer-debt purchaser Cabot Credit Management (CCM), Cabot's full owner, announced that it had acquired U.K.-based specialist debt buyer Marlin Financial Group (Marlin) for an enterprise value of £295 million. CCM will acquire Marlin's shares and will merge the "restricted group" (as defined in their respective bond terms and conditions) for their £150 million senior secured term notes with CCM's. The combination of the two entities creates a U.K. leader in the debt purchase and management industry, about twice the size of the two other industry leaders, Arrow Global and Lowell Group, in terms of on-balance-sheet portfolio value, debt purchase capacity, and estimated remaining collections.

We consider that Cabot's leverage will deteriorate materially following the acquisition. We believe the transaction also significantly reduces Cabot's debt-servicing capacity.

Our ratings on Cabot reflect the group credit profile (GCP) of the combined "restricted group" created by the acquisition, which we understand will comprise all of the subsidiaries of former CCM and Marlin groups. We assess the GCP at 'b'. The ratings on Cabot, which is an intermediate nonoperating holding company, also reflect our view

# Global A&T Electronics Ltd. Downgraded To 'B-' On Rising Legal And Refinancing Risks; Ratings Remain On Watch Negative

Standard & Poor's lowered its long-term corporate credit rating on Global A&T Electronics Ltd. (GATE) to 'B-' from 'B'. We also lowered our long-term ASEAN regional scale rating on the company to 'axB' from 'axBB-'. At the same time, we lowered our long-term issue ratings on GATE's US$625 million and US$502.257 million senior secured notes due 2019 to 'B-' from 'B'. The ratings remain on CreditWatch, where they were placed with negative implications on Nov. 18, 2013.

GATE is a Singapore-based outsourced semiconductor assembly and test services company.

"We downgraded GATE because the company's liquidity is likely to weaken because of the costs to resolve a legal dispute with bondholders and increased refinancing risk," said credit analyst Abhishek Dangra. "We also expect GATE's operating performance to remain weak in 2014 despite the company's recent acquisition of some Panasonic Corp. facilities."

More than 25% of GATE's bondholders (as required under the terms of the notes indenture) have filed a complaint with the Supreme Court of New York. The bondholders are seeking, among other things, damages and reversal of the exchange of second-lien notes done by GATE in September 2013. If the exchange is reversed, the second-lien notes of US$543 million will be due in October 2015 and GATE's refinancing risk will significantly increase.

GATE has "less-than-adequate" liquidity, as our criteria define the term. The company's lack of any core banking relationship limits its ability to raise bank loans. In recent years, the company has also not been successful in raising funds from equity markets. GATE's dispute with holders of senior notes, subsequent dilution of their security, and weak operating performance have further weakened the company's ability to access debt capital markets and refinance the notes. High dispute resolution costs or damages could put further pressure on GATE's liquidity.

We apply the unfavorable comparable rating adjustment modifier in view of the increased legal and refinancing risk for GATE, and the company's weaker operating performance than peers.

We do not expect any significant improvement in GATE's operating performance in 2014. GATE's scale and diversity (customer, geographic, and product) will not improve despite its parent UTAC Holdings Ltd.'s acquisition of three Panasonic facilities. This is because the acquisition will be done through a ring-fenced, wholly owned subsidiary of UTAC. We anticipate that GATE's EBITDA margins will be 25% to 27% in 2014.

"We kept the ratings on CreditWatch with negative implications to reflect the uncertainty about the nature and costs relating to GATE's dispute resolution," said Mr. Dangra.

We may downgrade GATE if the company's liquidity becomes weak as a result of cancellation of the exchange of the second-lien notes or if dispute resolution costs are significant. We may downgrade GATE by more than one notch if an "event of default" is triggered and appears likely to result in an acceleration of payment.

We may affirm the rating if the legal risk ends without any significant dispute resolution costs and the company's operating performance improves.

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that there appear to be no material barriers to cash flows to the holding company from the subsidiaries in the "restricted group."

*We consider that Cabot's leverage will deteriorate materially following the acquisition.*

Our recovery rating of '2' is based on an implied recovery for Cabot's £265 million and £100 million notes (and the acquired—subject to bondholders' consent—£150 bond of Marlin), at the low end of the 70% to 90% range, after repayment of the revolving credit facility.

The stable outlook on Cabot reflects our expectation that continued growth in collections will help the group, over time, to improve its cash flow coverage and leverage metrics in the next two years.

We could lower the rating if Cabot's leverage and debt-servicing capacity further deteriorate. We could also lower the rating if we see further signs of aggressive financial policy, a failure in the company's control framework, adverse changes in the regulatory environment, or material declines in total collections.

We could raise the rating if we observe ongoing, sustainable, and materially better leverage and debt-servicing metrics, in addition to sustained growth in cash flow generation and tangible equity. Cabot could, for example and among other things, rebuild a buffer close to 4x adjusted EBITDA to gross cash interest expenses and reduce its gross debt to adjusted EBITDA to about 2.5x to 3x.

We could also raise the rating if we observe over time that Cabot's consolidating leadership position in the industry brings it long-lasting tangible benefits. For example, Cabot could strengthen its relationships with debt sellers while having improved negotiation capacity on debt pricing.

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## Cablevision Systems Corp. Rating Lowered To 'BB-' And Removed From CreditWatch On Cable Segment Pressure

Standard & Poor's lowered its ratings on Bethpage, N.Y.-based Cablevision Systems Corp. and related entities, including the corporate credit rating to 'BB-' from 'BB', and removed all ratings from CreditWatch, where we had placed them with negative implications on Nov. 14, 2013. The rating outlook is stable.

"The downgrade incorporates our revised view of Cablevision's business risk profile to 'satisfactory' from the prior 'strong' along with its 'highly leveraged' financial risk profile," said credit analyst Richard Siderman. "Our revision of business risk recognizes the likelihood of a continuing loss of video subscribers from these mature cable properties along with continuing competitive pressure from the availability of Verizon's rival FiOS service in much of Cablevision's service territory," he added.

We expect cable system maturity, the twin secular industry trends of video subscriber losses and higher programming costs, along with competition to result in the cable segment EBITDA margin remaining in the low 30% area, somewhat below that of peers, which typically range from the mid-30% area up to 40%. This expectation results in our view that debt to EBITDA will be in the low-to-mid 5x area, including our adjustments, for the next two years.

The stable rating outlook recognizes that despite competitive pressure, revenue from Cablevision's well-bundled cable customers should be no more than only modestly lower in 2014 with video customer losses partly offset

by selective rate increases. Based on our expectation of a consolidated EBITDA margin in the high-20% area, we expect debt leverage to be in the low- to mid-5x area in 2014, consistent with a highly leveraged financial risk profile.

We could lower the rating if Cablevision encounters a greater-than-anticipated level of competition from FiOS, in particular aggressive, and sustained, triple-play pricing that leads to erosion of all revenue generating unit (RGU) categories and average revenue per video customer substantially below the $165 level. That scenario could weaken the consolidated EBITDA margin to the mid-20% area, or lower, and lead to debt leverage over 6x.

Consideration of a higher rating would be based on an improvement in the cable segment EBITDA margin toward the mid-30% area that would enable debt leverage to improve to the mid-4x area on a sustained basis. That would most likely stem from some material, although likely selective, rate increases in combination with a lower-than-anticipated loss of basic video subscribers, within the context of the significant FiOS competition.

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## Uncertainties In Bangladesh And Thailand Raise Risk But Stable Economies Anchor Sovereign Ratings

Political uncertainties will stay elevated in Bangladesh and Thailand for some time and they could hurt investor confidence and weaken economic activity, said Standard & Poor's in a report titled *"Election Woes In Bangladesh And Thailand Raise Risk But Don't Yet Undermine Sovereign Ratings,"* published Feb. 18, 2014, on RatingsDirect.

According to the report, Standard & Poor's expects the sovereign credit ratings on the two governments to remain unchanged over the next two years. This assessment partly reflects our belief that the tensions will not boil over into prolonged and widespread violence.

"Any prolonged and widespread violence could exacerbate political instability and deal sustained damage to these economies, which have been resilient to past political turmoil," said credit analyst Kim Eng Tan.

The main opposition parties in both Bangladesh and Thailand boycotted the respective elections called early in 2014, thereby weakening their legitimacy and undermining the strength of the democratic process.

"The roots of the disagreements between political groups in the two countries run deep, their resolutions are unlikely to be straightforward," Mr. Tan said. "The election boycotts mean that both governments are likely to face questions about their legitimacy."

We expect relatively stable economic conditions, in the absence of widespread and sustained violence, to anchor sovereign creditworthiness in Bangladesh and Thailand in the next six to 24 months. Growth in both economies has been resilient during previous political upheavals.

"Bangladesh and Thailand possess strong external balances, relatively low debt and interest burdens, and low inflation. These attributes have helped to stabilize sovereign rating fundamentals amid occasional political volatilities," Mr. Tan said.

Although we don't expect to have to change the two sovereign ratings in the next 24 months, political instability has somewhat weakened the credit profile for Thailand and Bangladesh.

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# Lack of Consistency, Comparability, And Transparency In Financial Reporting Can Distort Analysis

Few investors will buy a company's debt or equity without at least a cursory look at its income statement, balance sheet, statement of cash flows, accompanying notes, and the management discussion and analysis. Standard & Poor's Rating Services believes financial statements too often lack the consistency, comparability, and transparency investors and other financial statement users need for analysis. The reports upon which global financial statement users depend are an amalgam of accounting standards, regulatory mandates, and management discretion, which can result in an unpredictable mix of information—or lack thereof—that makes analyzing financial statements more complicated than we believe necessary. Without an understanding of what financial metrics actually measure, how different industries or comparable companies in the same industry might use those numbers, and how disparate standards can change the disclosures afforded the public, investors risk misunderstanding a company's financial strength and misallocating their capital.

## Overview

- Financial reports present opportunities to distort a company's true financial position through managerial discretion, such as with the use of non-GAAP measures and exceptional accounting items. This skews the comparability of company financial reports, complicating investor decisions.
- We make our own analytical adjustments to company financial reports to produce measures that meaningfully reflect our view of underlying economic realities and improve comparability among companies.
- Some proposed changes to accounting standards indicate that global accounting convergence is becoming less likely, with accounting standard-setters, investors, and other financial statement users taking varied positions.
- We advocate greater independent audit assurance about compliance, with regulatory guidance on non-GAAP and other management-reported financial measures.

The uncertainty around financial reporting is a result of accounting and disclosure standards that have yet to catch up with the massive changes in recent business transactions. There are new industries and products, cross-border capital flows and offshore manufacturing are routine, and regulators and auditors in different jurisdictions recognize the need to create new standards and find common ground. Some companies believe non-Generally Accepted Accounting Principles (non-GAAP) supplemental measures can better reflect their true financial performance; others counter that companies may be taking advantage of the flexible nature of non-GAAP measures, which are extensively used by some management teams and investors in these companies, to favorably represent their financial results. It may be impossible to bring perfect global transparency and consistency to financial reporting. We believe investors and other financial statement users need enhancements in accounting, financial reporting, and the level of audit assurance provided to get better analytical insights into companies' financial performance.

We are conscious of the existing difficulties when using financial reports in our rating process. If we see inconsistencies or differences in the economics in accounting and financial reporting methodologies among comparable companies, we make, as always, analytical adjustments to derive our own view of a company and seek any other critical information directly from management to improve the analytical relevance and consistency of the key performance metrics we use in our credit analysis. That said, other stakeholders are not always sanguine about the possibilities: Some believe accounting and financial reporting have become unnecessarily complex, which in itself may be part of the problem investors face in making decisions. Others believe proposed accounting and financial reporting standards in some areas will not simplify concerns about analysis, but make it more difficult. Therefore, while we work to bring consistency to our analyses, we also see places where stakeholders in the capital markets could benefit from improved disclosure, comparability, and consistency.

## The Gaps In GAAP, IFRS, And The Audit

We believe managements should provide qualitative—and where practicable—quantitative disclosures about how they determine non-GAAP and other supplemental measures, including why management decided any particular item was appropriate for exclusion from reported GAAP or International Financial Reporting Standards (IFRS) amounts. With this disclosure, investors and other users of financial statements could independently assess managements' judgments and assumptions.

*The statement of cash flows also is a key component in our ratings analysis that can lack consistency and comparability.*

We hope to see auditors—with specific guidance—provide independent assurance over how companies define and apply broadly used supplemental measures and nonrecurring or exceptional items undefined by U.S. GAAP or IFRS. These financial measures typically are found in the management discussion and analysis sections of a company's financial reports. Definitions for such measures as earnings before income, taxes, depreciation, and amortization (EBITDA), free operating cash flow, or adjusted debt, can differ even among companies in the same industry. Such financial measures are unaudited and may not be calculated or defined with the same neutrality as GAAP or the IFRS measures. We believe a consensus on the definition and use of these terms and uniformly applied audit procedures would be a significant step in making financial statements more comparable and less difficult to analyze *(see "Non-GAAP Measures Are Useful, But Could Benefit From Standard Definitions And Independent Assurances," on p. 40)*.

As an example, EBITDA is a common measure used in financial analysis and many companies report it when presenting financial information, yet its calculation is not defined under GAAP or IFRS. Depending on how management defines EBITDA, it can exclude selected costs and cash flows, painting a more positive picture of its performance, which also can skew peer comparability. We have a consistent methodology for deriving this measure, routinely applied as part of our analysis. In the U.S., the SEC allows companies to define EBITDA as they choose, but places restrictions on a company's use and presentation of the measure, and requires the company to reconcile any non-GAAP measure with the most directly comparable GAAP measure *(see "EBITDA: It's All In The Definition," on p. 16)*.

The statement of cash flows also is a key component in our ratings analysis that can lack consistency and comparability. The Financial Accounting Standards Board (FASB) has refrained from providing guidance on the appropriate presentation and classification of business transactions in the statement of cash flows, instead leaving it to each company to apply some broad principles. We believe these principles have proven insufficient in some circumstances, and can lead to incomparable presentations of similar transactions. This is another instance where we adjust company financial statements to establish consistent comparisons, where information is available *(see "The*

*Statement Of Cash Flows: Comparing The Incomparable," on p. 22).*

## The Difference Between Recurring And Exceptional Items

Investors typically consider a company's underlying profit measures when making asset-allocation decisions, but we believe inconsistencies—where expenses are reported as nonrecurring or not—can distort those earnings. We have seen this at companies reporting in Europe, where management has discretion to decide which costs (or revenues) can be considered one-time items. Companies we sampled on the nonfinancial FTSE 100 tend to identify reconciling items that boost their own adjusted profit figures more often than items that decrease them. We also have seen cases where companies excluded so-called exceptional restructuring charges from their underlying profits, after recording those charges for several years running. Such exclusions, whether of credits or charges, are often used to give investors only the most favorable picture *(see "Why Inconsistent Reporting Of Exceptional Items Can Cloud Underlying Profitability At Nonfinancial FTSE 100 Companies," on p. 32).*

Management's approach to the considerations applied when determining what to include in underlying profit has come to the attention of U.K. regulatory authorities, and we believe we could be seeing the start of a more rigorous attitude toward defining them. However, the effects of new guidance likely will be gradual, and disclosures may take some time to reach full consistency and comparability across companies, if at all.

## Banks Should Make Disclosures More Robust

Despite the enormous amount of data U.S. banks file with the SEC and the Federal Reserve, we believe much of it still lacks the completeness, transparency, and consistency that would enable a fuller understanding of financial risks and deeper analysis of these institutions. Many filings remain opaque about banks' litigation risks, equity components, interest-rate sensitivities, liquidity and collateral management, repurchase agreements, hedging activities, and fair value measurements of securities holdings. The lack of consistent information in these areas can hinder an investor's understanding of a bank's financial position and, more widely, blunt confidence in the industry at a time when memories of the financial crisis remain vivid *(see "U.S. Banks' Disclosures Have Grown, But Many Financial Risks Remain Opaque," on p. 52).*

Weak disclosures tend to mainly benefit poorly managed banks because they are not compelled by law, regulation, or accounting disclosure requirements to be fully transparent. The irony is that banks choosing to disclose information other banks do not provide can suffer, if investors believe they are more exposed to risks others leave hidden.

## International Inconsistency And Lack Of Convergence Exacerbate The Problem

Global capital markets require a comprehensive solution for accounting and financial reporting and a converged auditing model. We see multiple versions of standards proposed on the same topics that may impede global consistency and comparability, further complicating analysis for investors and other financial statement users.

The FASB and IASB proposed changes to accounting and financial reporting standards that will create meaningful distinctions in company results, affecting reported financial measures. These include far-reaching changes to the credit impairment and insurance contracts models in the financial services industry *(see "FASB's Proposal Set To Revamp Accounting For Credit Losses, But Fails To Achieve Convergence With International Accounting," published July 11, 2013, on RatingsDirect; "IASB's Proposal Set To Revamp Accounting For Credit Losses, But Fails To Achieve Convergence With U.S. Accounting," published July 16, 2013; and "Global Insurance Accounting Proposals Signal Radical Change, But Fall Short Of Complete Convergence," published Oct. 16, 2013).* Further, public auditor reports are undergoing potential changes to communicate more information to investors regarding audits based on separate sets of standards—one proposed by the International Auditing and Assurance Standards Board (IAASB), the other by the Public Company Accounting Oversight Board (PCAOB). We have encouraged the FASB to develop standards jointly with the IASB and, separately, for the PCAOB and the IAASB to work together in making these important changes to the audit reporting model *(see "Proposed Changes To The Auditor's Report May Affect Analysis," published Dec. 9, 2013).*

In addition, we have observed that investors and other financial statement users differ in their levels of support about the quality and relevance of the proposed changes by the FASB and IASB in accounting and financial reporting and the PCAOB and IAASB in the auditor reporting model *(see "Why U.S. Financial Services Investors Are Concerned That Proposed Accounting Rules Will Impede Decision Making," on p. 59).* We believe the capital markets would benefit from the development of a global accounting system that can accommodate the increasing complexity of business and finance. More than ever, investment opportunities are global, so the need for improved accounting and financial reporting principles and enhanced, uniformly applied audit procedures are increasingly important. **CW**

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# EBITDA
# It's All In The Definition

### Overview

- Although EBITDA is a key part of the financial information many companies present, it is a non-GAAP measure , and different companies approach calculating it differently, which skews comparability.
- The SEC requires reconciliation of non-GAAP measures to the nearest GAAP measure, which provides greater transparency.
- Because EBITDA remains useful to our analysis, we have a consistent definition of EBITDA and make a variety of adjustments to ensure greater comparability.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a common measure used in financial analysis and many companies report it when presenting financial information. However, neither U.S. generally accepted accounting principles (GAAP) nor International Financial Reporting Standards (IFRS) define how companies should calculate EBITDA, which makes it a non-GAAP measure *(see sidebar)*.

This lack of standards leads to incomparability among peer companies, which presents challenges to users of financial information. Additionally, EBITDA may exclude a number of costs and cash flows and, therefore, can sometimes paint an overly rosy picture of a company's performance. These risks and limitations contribute to how Standard & Poor's Ratings Services calculates and uses this popular, yet enigmatic, measure.

## Non-GAAP Reconciliations Can Be Helpful To Analysis

We see a lot of variation in what companies call EBITDA or adjusted EBITDA, arising from the absence of standards; how companies use these metrics (as an earnings or cash flow measure); and managements' views on how best to represent these measures. Despite the potential variability, the SEC allows companies to report non-GAAP measures but places restrictions on their use and presentation. To protect investors, the SEC requires companies to provide reconciliations of their non-GAAP measures to the nearest GAAP measure *(see table 1)*.

However, in most cases the reconciliation is not so straightforward. Companies often make various adjustments to arrive at their EBITDA, stemming from a fundamental view as to what EBITDA represents, or treating certain activities as nonrecurring one-time items.

Examples of activities that companies treat differently than the base definition of EBITDA include:

- Share-based compensation expense;
- Impairment charges;
- Reorganization costs;
- Equity in earnings of unconsolidated affiliates net of dividends;
- Acquisition-related expenses;
- Foreign currency gains or losses;
- Unusual or special gains or losses;
- Interest income;
- Amortization not associated with property, plant, and equipment; and
- Constant currency adjustments.

Comparing companies' reconciliations to adjusted EBITDA shows this variability *(see table 2)*.

Some might question whether these reconciliations and the resulting adjusted EBITDA are in fact comparable. For example, Rite Aid added back a "gain on sale of assets," but Safeway did not. Perhaps Safeway did not have a gain on asset sales and would have added it back if it did. Alternatively, Safeway may have had gains on asset sales but did not adjust EBITDA. The problem is that in the absence of standards, we just do not know whether EBITDA one company reports is calculated consistently with EBITDA others report.

While the SEC's requirements do not necessarily lead to comparability, they do promote transparency, which we find helpful in our analysis. The reconciliations expose many items that we treat similarly in our measure of EBITDA (e.g., we add back share-based compensation).

We find it particularly helpful when companies electively distinguish between non-GAAP items they exclude on a definitional basis (such as share-based compensation, which is paid for with equity rather than cash) and those items they exclude based on the activity being considered

## Securities and Exchange Commission's (SEC) Non-GAAP Measure Requirements

The SEC defines non-GAAP measures as numeric measures of financial performance, financial position, or cash flows that exclude (or include) amounts that are included (or excluded) in the most directly comparable measures, such as net income, calculated and presented in accordance with generally accepted accounting principles (GAAP) in the financial statements.

When companies include non-GAAP measures, such as EBITDA, in their public filings, the SEC provides disclosure guidelines.

Companies must provide:

- A presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP.
- A reconciliation of the differences between the non-GAAP measure used and the most comparable financial measure presented in accordance with GAAP.
- The reasons why management believes that the non-GAAP measure provides useful information and any additional purposes for which management uses the non-GAAP measure.

Companies must not:

- Adjust non-GAAP measures to eliminate or smooth nonrecurring, infrequent, or unusual losses or gains, if the company had a similar item in the past two years or it reasonably expects a similar item to recur within two years.
- Present non-GAAP measures on the face of the financial statements or in the accompanying footnotes but rather in other information accompanying the financial statements.
- Use titles or descriptions that are the same as or confusingly similar to GAAP.

The SEC also requires that if a company provides some variation of EBITDA that is calculated differently than the broadly understood definition, they must provide a distinguishing title, e.g., adjusted EBITDA.

Some companies choose to reconcile EBITDA (or adjusted EBITDA) to net income, others to cash flows from operations, and some to both. When a company discloses that the most directly comparable GAAP financial measure for EBITDA is net income, we understand that the company views EBITDA as an earnings-based performance measure. If the company states that the comparable measure is operating cash flows, we know that the company views EBITDA as a cash flow measure.

non-recurring (such as reorganization costs). This allows us to more readily identify the purported nonrecurring activity and make our own judgments regarding its treatment. For instance, Praxair appears to first highlight nonrecurring adjustments to net income, followed by a reconciliation to adjusted EBITDA from adjusted net income *(see table 3)*.

## A Consistent Definition And Adjustments Are Necessary To Mitigate The Risks Of Using EBITDA

Given the risks of using EBITDA, one might wonder how we guard against them. First and foremost, we do not rely upon EBITDA as presented by companies. Our ratings are relative, and achieving comparability in the metrics we use to evaluate companies is critical to arriving at our assessment of relative creditworthiness. We therefore have developed our own standard definition of EBITDA in our Ratios And Adjustments criteria *(see "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013, on RatingsDirect)*:

- 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.

Our definition of EBITDA is top-down (we begin with revenue and subtract the expenses that meet our definition), instead of bottom-up (which starts with earnings and adds back all unwanted activity), as in the traditional definition of EBITDA. This is because there often are a host of non-operating income and expenses at the bottom of the income statement that we may exclude.

**Table 1 | Plains All American Pipeline LP***

| (Mil. $) | |
|---|---|
| Net income | 1,127 |
| Income taxes | 54 |
| Depreciation and amortization | 482 |
| Interest expense | 288 |
| EBITDA | 1,951 |

*For the year ended Dec. 31, 2012.
*Source: Form 10-K.*

We have devised an approach to determining what underlying activities we consider core to EBITDA by establishing a relationship between EBITDA and cash flows from operations. The following excerpts from our Ratios And Adjustments criteria explain our approach:

- 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 funds from operations (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.

An example of activity that would be included in EBITDA is 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.

Activity that would be excluded from EBITDA is the gain or loss on the sale of property, plant, and equipment (PP&E). Under accounting standards, proceeds from the sale of PP&E are classified in the statement of cash flows as an investing cash flow rather than an operating cash flow. As such, we treat a gain or loss from the sale of PP&E as a non-operating activity and exclude this from our calculation of EBITDA.

While companies may generally exclude these acquisition-related costs and gains and losses on the sale of PP&E from their EBITDA calculation because they view them as noncore or nonrecurring, the absence of standards leads to inconsistent EBITDA calculations from company to company.

Our definition of EBITDA does not preclude our analysts from treating certain reported activities as nonrecurring in nature and therefore excluding them from our computed metrics. This decision is independent of our base definition. Therefore, activity that is determined to be operating in nature may be excluded from EBITDA based on it being nonrecurring. However, an activity that is considered to be nonoperating in nature (such as gains or losses on sales of long-lived assets) may not be included in EBITDA, even if viewed as a recurring activity.

Aside from our standard definition, we also make analytical adjustments to the reported amounts for a number of reasons, including to account for differing treatment or presentation of similar transactions because of policy elections or accounting regime differences. An example is our adjustment for capitalized development costs that can receive disparate treatment depending on management's judgments, a company's industry, or the applicable financial reporting standards. We therefore adjust to record as expense all development costs that a company capitalizes in the period, except for development costs for internal-use software.

Not all of these defenses against incomparability combat the limitations of using a potentially incomplete representation of cash flows. We therefore have a number of other ratios that provide different perspectives of a company's leverage. These include: FFO to debt, CFO to debt, free operating cash flow (FOCF) to debt, and discretionary cash flow (DCF) to debt.

## How We Use EBITDA

We use EBITDA in two important ways: as part of our assessment of competitive position (where, among other things, we may use it to evaluate a company's level of profitability and its volatility of profitability) and as the denominator in one of our core cash flow/leverage ratios—debt to EBITDA. *(See Corporate Methodology, published Nov. 19, 2013, and Corporate Methodology: Ratios And Adjustments. For a deeper understanding of how we use EBITDA, see sections D and E of our Corporate Methodology.)*

However, given the acknowledged risks and limitations to EBITDA, why use it in our analysis? Our criteria state that:

- 237. EBITDA is a widely used, and therefore a highly comparable, indicator of cash flow, although it has significant limitations. Because EBITDA derives from the income statement entries, it can be distorted by the same accounting issues that limit the use of earnings as a basis of cash flow. In addition, interest can be a substantial cash outflow for speculative-grade companies and therefore EBITDA can materially overstate cash flow in some cases. Nevertheless, it serves as a useful and common starting point for cash flow analysis and is useful in ranking the financial strength of different companies.

We consider EBITDA as being highly comparable because it provides a common language of comparison when calculated in a uniform and consistent manner using our methodology. While EBITDA reporting can be quite variable, we believe that, once we standardize the calculation of EBITDA via our approach, it can be useful to our analysis. EBITDA and debt-to-EBITDA performance and leverage metrics are commonly used in the marketplace, and we believe debt-to-EBITDA is an instructive debt payback ratio that can effectively discriminate between prospective defaulters and nondefaulters.

Table 2 | **Adjusted EBITDA**

| (Mil. $) | Rite Aid Corp. | Alaska Communications Systems Group Inc. | Safeway Inc. | Magellan Midstream Partners LP |
|---|---|---|---|---|
| Fiscal year end | March 2, 2013 | Dec. 31, 2012 | Dec. 29, 2012 | Dec. 31, 2012 |
| Net income (loss) | 118 | 17 | 597 | 436 |
| Interest expense | 515 | 40 | 304 | 112 |
| Income tax (benefit) expense | (111) | 6 | 262 | — |
| Reduction of tax indemnification asset | 91 | — | — | — |
| Depreciation and amortization expense | 414 | 51 | 1,134 | 130 |
| LIFO (credits) charges | (148) | — | 1 | — |
| Property impairment charges | — | — | 47 | — |
| Property impairment charges and tax expense from discontinued operations | — | — | 28 | — |
| Gain on sale of assets, net | (17) | (3) | — | |
| Asset retirements and impairments | — | — | — | 13 |
| Lease termination and impairment charges | 71 | — | — | — |
| Stock-based compensation expense | 18 | 4 | 55 | 8 |
| Loss on debt retirements, net | 141 | — | — | — |
| Closed facility liquidation expense | 5 | — | — | — |
| Customer loyalty card program revenue deferral | 27 | — | — | — |
| Loss on extinguishment of debt | — | 1 | — | — |
| Equity in earnings of unconsolidated affiliate | — | — | (18) | — |
| Return of capital from equity investment | — | — | 1 | — |
| Derivative losses (gains) associated with future product transactions | — | — | — | 6 |
| Derivative losses (gains) associated with previous period product transactions | — | — | — | 4 |
| AWN transaction related costs | — | 6 | — | — |
| Lower-of-cost-or-market adjustments | — | — | — | 1 |
| Houston-to-El Paso cost of sales adjustments | — | — | — | 2 |
| Other | 4 | — | — | 5 |
| Adjusted EBITDA | 1,128 | 122 | 2,410 | 716 |

*Source: Forms 10-K.*

## EBITDAX: Just One Of The Many Flavors

In the U.S. and elsewhere, oil and gas exploration and production (E&P) companies choose between two accounting methods: full cost or successful efforts, which differ in terms of what investment outlays companies capitalize or expense. A full-cost company capitalizes all property acquisition, exploration, and development costs in cost centers, which can be as sizable as the company's operations in an entire country. Under the more conservative, successful-efforts accounting approach, a company only capitalizes property acquisition costs and successful exploratory drilling, such as drilling that results in the discovery and development of a commercial oil and gas field, and related development costs. Successful-efforts companies calculate depreciation, depletion, and amortization (DD&A) based on production of individual fields, while full-cost companies calculate DD&A based on production of the much larger cost centers. Companies using the successful-efforts method report exploration expenses as a separate line item in the income statement. Full-cost companies capitalize exploration costs and do not report exploration expense separately in the income statement.

Given this disparity in how these costs are accounted for under the two methods, it is standard E&P industry practice to use a measure commonly called EBITDAX, whereby exploration expenses of successful-efforts companies are added back to earnings, as with depreciation. For example, Anadarko Petroleum Corp. disclosed EBITDAX and reconciled it to income before income taxes *(see table 4)*.

Recasting the financial statements of full-cost and successful-efforts companies on a comparable basis is not possible because the needed, detailed information going back numerous years is not publicly available. However, to gain comparability within the sector, we adjust our calculation of EBITDA to exclude all exploration costs, thereby increasing EBITDA. In our view, this adjustment provides sufficient comparability among companies using either accounting treatment. Our adjusted EBITDA measure conforms to the industry standard of EBITDAX. With our adjustment, we then calculate EBITDA-related ratios using our equivalent of EBITDAX *(see "Key Credit Factors For The Oil And Gas Exploration And Production Industry," published Dec. 12, 2013)*. In addition to debt-to-EBITDA, we use other cash flow and leverage measures in the E&P sector that are not adjusted for exploration expenses such as FFO to debt, FOCF to debt, and DCF to debt. **CW**

**Table 3 | Praxair Inc.***

| (Mil. $) | |
|---|---|
| Net income | 1,692 |
| Pension settlement | 6 |
| Income tax benefit | (55) |
| Cost reduction program | 38 |
| Adjusted net income | 1,681 |
| Add: adjusted noncontrolling interests | 54 |
| Add: interest expense | 141 |
| Add: adjusted income taxes | 660 |
| Add: depreciation and amortization | 1,001 |
| Adjusted EBITDA | 3,537 |

*For the year ended Dec. 31, 2012.
*Source: Form 10-K.*

**Table 4 | Anadarko Petroleum Corp.***

| (Mil. $) | |
|---|---|
| Income (loss) before income taxes | 3,565 |
| Exploration expense | 1,946 |
| DD&A | 3,964 |
| Impairments | 389 |
| Deepwater Horizon settlement | 18 |
| Algeria exceptional profits tax settlement | (1,797) |
| Tronox-related contingent loss | (250) |
| Interest expense | 742 |
| Unrealized (gains) losses on derivatives | 377 |
| Realized (gains) losses on other, net | 66 |
| Less net income attributable to noncontrolling interests | (54) |
| Consolidated adjusted EBITDAX | 8,966 |

*For the year ended Dec. 31, 2012.
*Source: Form 10-K.*

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# The Statement Of Cash Flows

## Comparing The Incomparable

### Overview

- Insufficient guidance on the appropriate presentation and classification of business transactions has led to differences in how companies present their statements of cash flows.
- We believe that greater consistency and transparency would result from offering fewer options and providing more interpretive guidance.
- Lack of comparability between different companies' statements of cash flows is an impediment to financial statement analysis.
- We will continue to scrutinize statements of cash flows and make adjustments to improve comparability among peers.

The statement of cash flows is a key component of Standard & Poor's Ratings Services' corporate credit analysis, and the comparability of this information between peer companies is critical. The problem is that no two statements of cash flows are alike. To deal with these inconsistencies in financial reporting, we often make adjustments to the reported amounts and, at other times, consider these differences qualitatively *(see "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013, on RatingsDirect)*. In our view, there are ways to improve the transparency and comparability of the statement of cash flows to better enable financial statement analysis.

The statement of cash flows has long suffered as a third wheel to the other two primary statements: the balance sheet and income statement. The Financial Accounting Standards Board (FASB) has historically refrained from providing guidance on the appropriate presentation and classification of business transactions in the statement of cash flows when it issues new standards, instead leaving issuers to apply the principles contained under Accounting Standards Codification 230 "Statement of Cash Flows" (ASC 230). We believe that these principles have proven insufficient in some circumstances, leading to incomparable presentations of similar transactions.

Although we broadly agree with the presentation that U.S. generally accepted accounting principles (GAAP) prescribe, it is our view that several aspects of the statement of cash flows could benefit from presentation and classification enhancements and more interpretive guidance for companies. In this article, we address the presentation of the following items:

- The purchase of assets to be leased,
- Cash paid for interest,
- Derivative and hedging activity, and
- Noncash transactions.

Prior to 2011, the FASB and the International Accounting Standards Board (IASB) were jointly working to establish a standard that would guide the broader organization and presentation of information in financial statements, including the statement of cash flows, as part of their Financial Statement Presentation project. However, they shelved the project in order to focus on other priorities. Hopefully, if the boards resume deliberations, they will be able to resolve some of these issues. In the meantime, we recommend:

- Promoting more consistency in application and greater transparency as to how amounts are classified in the statement via less optionality and more interpretive guidance,
- Allowing for the bifurcation of singular cash flows between categories,
- Allowing for the judicious use of constructive receipt and disbursement or requiring that noncash activity be included within the statement itself, and
- Potentially looking to the nature of the original noncash transaction to determine the classification of subsequent cash flows.

**Table 1 | Cash Flow Summary: XYZ Corp.**

(Mil. $)

| | 201X |
|---|---|
| Cash flow from operations | 11,700 |
| - Capital expenditures | (3,200) |
| Free operating cash flow | 8,500 |
| - Cash dividends | (4,500) |
| Discretionary cash flow | 4,000 |
| - Acquisitions | (3,700) |
| + Asset disposals | 400 |
| + Equity issuances | 200 |
| - Share repurchases | (100) |
| +/- Other sources (uses) of cash | 600 |
| Cash flow available for debt repayment | $1,400 |

**Table 2 | Outerwall Inc. Consolidated Statements Of Cash Flows ($000s)**

| | —Year ended Dec. 31— | | |
|---|---|---|---|
| **Operating activities** | **2013** | **2012** | **2011** |
| Net income | $174,792 | $150,230 | $103,883 |
| **Adjustments to reconcile net income to net cash flows** | | | |
| Depreciation and other | 193,700 | 179,147 | 145,478 |
| Amortization of intangible assets and deferred financing fees | 13,461 | 7,504 | 5,182 |
| Share-based payments expense | 16,831 | 19,362 | 16,211 |
| Excess tax benefits on share-based payments | (3,698) | (5,740) | (2,471) |
| Deferred income taxes | (10,933) | 87,573 | 60,076 |
| Impairment expense | 32,732 | — | — |
| Loss from discontinued operations, net of tax | — | — | 11,068 |
| (Income) loss from equity method investments, net | (19,928) | 5,184 | 1,591 |
| Non-cash interest on convertible debt | 3,866 | 7,109 | 6,551 |
| Loss from extinguishments of callable convertible debt | 6,013 | — | — |
| Other | (2,039) | (4,100) | (95) |
| **Cash flows from changes in operating assets and liabilities** | | | |
| Accounts receivable, net | 7,978 | (17,061) | (15,289) |
| Content library | (22,459) | (30,693) | (2,062) |
| Prepaid expenses and other current assets | (50,542) | (6,963) | (4,869) |
| Other assets | 230 | 858 | 1,769 |
| Accounts payable | (2,252) | 58,248 | 12,550 |
| Accrued payable to retailers | (4,088) | 10,461 | 30,826 |
| Other accrued liabilities | (9,573) | 2,787 | 36,117 |
| Net cash flows from operating activities | 324,091 | 463,906 | 406,516 |
| **Investing activities** | | | |
| Acquisition of ecoATM, net of cash acquired | (244,036) | — | — |
| Purchases of property and equipment | (157,669) | (208,054) | (179,236) |
| Proceeds from sale of property and equipment | 13,344 | 1,131 | 695 |
| Receipt of note receivable principal | 22,913 | — | — |
| Proceeds from sale of business, net | — | — | 8,220 |
| Acquisition of NCR DVD kiosk business | — | (100,000) | — |
| Cash paid for equity investments | (28,000) | (39,727) | (4,912) |
| Net cash flows from investing activities | (393,448) | (346,650) | (175,233) |

## Standard & Poor's Approach To Analyzing The Statement Of Cash Flows

Before addressing specific problem areas, it might be helpful to recap how Standard & Poor's generally uses the information in an issuer's statement of cash flows to derive the various cash flow metrics we employ in corporate ratings. We begin to measure cash flows using cash flow from operations (CFO). By deducting capital expenditures from CFO, we arrive at free operating cash flow (FOCF), which we use as a proxy of a company's cash generated from core operations. Next, we calculate the company's discretionary cash flow (DCF) by subtracting cash dividends from FOCF. DCF is a measure of cash flows after consideration of all nondiscretionary cash flows. Finally, to arrive at cash flow available for debt repayment, we subtract from or add to DCF: cash used for acquisitions, received from asset disposals, received from equity issuances, used for share repurchases, and other miscellaneous sources and uses of cash. This metric represents the extent to which a company's cash flow from all nonfinancing sources has been sufficient to cover all internal needs. *(See Appendix C to "Corporate Methodology," published Nov. 19, 2013, for further discussion of how we use these metrics, and table 1.)*

We then apply our analytical adjustments to these subtotals for items such as pensions and leases to arrive at the adjusted metrics we use in our credit analysis. See *"Corporate Methodology: Ratios And Adjustments,"* published Nov. 19, 2013.

## Presentation And Classification Risk

The statement of cash flows is, in concept, simple. It is, by definition, on a cash basis, thereby ignoring the complexities of accrual accounting that require consideration of when to recognize and how to measure amounts in the income statement and balance sheet. Instead, the primary analytical risk concerns presentation or classification. This includes not only the classification of cash flows as operating, investing, or financing activities but also the presentation within each of these categories, because users of financial statements often derive their own metrics (as is the case with our FOCF and DCF metrics). The lack of comparability in the construct of the statement makes it difficult for financial statement users to arrive at comparable metrics across peer companies. The smaller the subset of the cash flow statement used for analysis, the greater the exposure to this presentation and classification risk.

The guidance ASC 230 offers on the construct of the statement of cash flows largely centers around how to classify individual cash flows among the three categories (operating, investing, and financing activities). Even then, disparity remains in how companies within the same industry present similar business transactions in the statement. A number of factors contribute to this presentation risk: differences between the primary accounting regimes—U.S. GAAP and international financial reporting standards (IFRS), ambiguity in the authoritative guidance, policy elections, adherence to form over substance, and the potential to misapply the accounting guidance.

With this backdrop in mind, we look at some specific issues that can lead to disparate statement of cash flow presentation.

**Table 3 | Netflix, Inc. Consolidated Statements Of Cash Flows ($000s)**

| | —Year ended December 31— | | |
|---|---|---|---|
| **Cash flows from operating activities** | **2013** | **2012** | **2011** |
| Net income | $112,403 | $17,152 | $226,126 |
| **Adjustments to reconcile net income to net cash provided by operating activities** | | | |
| Additions to streaming content library | (3,049,758) | (2,515,506) | (2,320,732) |
| Change in streaming content liabilities | 673,785 | 762,089 | 1,463,955 |
| Amortization of streaming content library | 2,121,981 | 1,591,218 | 699,128 |
| Amortization of DVD content library | 71,325 | 65,396 | 96,744 |
| Depreciation and amortization of property, equipment and intangibles | 48,374 | 45,469 | 43,747 |
| Stock-based compensation expense | 73,100 | 73,948 | 61,582 |
| Excess tax benefits from stock-based compensation | (81,663) | (4,543) | (45,784) |
| Other non-cash items | 5,332 | (8,392) | (4,050) |
| Loss on extinguishment of debt | 25,129 | — | — |
| Deferred taxes | (22,044) | (30,071) | (18,597) |
| **Changes in operating assets and liabilities** | | | |
| Other current assets | 62,234 | (5,432) | 1,436 |
| Accounts payable | 18,374 | (4,943) | 23,968 |
| Accrued expenses | 1,941 | 9,806 | 65,560 |
| Deferred revenue | 46,295 | 20,676 | 21,613 |
| Other non-current assets and liabilities | (8,977) | 4,719 | 3,016 |
| Net cash provided by operating activities | 97,831 | 21,586 | 317,712 |
| **Cash flows from investing activities** | | | |
| Acquisition of DVD content library | (65,927) | (48,275) | (85,154) |
| Purchases of property and equipment | (54,143) | (40,278) | (49,682) |
| Other assets | 5,939 | 8,816 | 3,674 |
| Purchases of short-term investments | (550,264) | (477,321) | (223,750) |
| Proceeds from sale of short-term investments | 347,502 | 282,953 | 50,993 |
| Proceeds from maturities of short-term investments | 60,925 | 29,365 | 38,105 |
| Net cash used in investing activities | (255,968) | (244,740) | (265,814) |

**Operating or investing activity?**
U.S. GAAP is fairly prescriptive as to where companies should classify various types of cash flows on the statement, but sometimes what category certain cash flows fall under is unclear. ASC 230 addresses this by requiring that the entire cash flow be classified depending on the activity that is likely to be the predominant source of cash flows, but that is often open to interpretation.

More specifically, ASC 230-10-45-22 states:

*"Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the entity or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the entity or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities."*

This can lead to companies treating very similar transactions dissimilarly. Take, for example, the treatment of cash paid for the acquisition of the content library in the DVD rental industry. Outerwall Inc. (BB+/Stable/—) has interpreted the FASB guidance and classified cash paid for its content library as an operating activity *(see table 2)*. DISH Network Corp. (BB-/Negative/—), which acquired Blockbuster in 2011, classifies the acquisition of its content library similarly.

Netflix Inc. (BB-/Stable/—) has interpreted the guidance differently. It has determined that cash paid for the acquisition of its DVD content library is similar to the purchase of a fixed asset and has classified it as an investing activity *(see table 3)*. Netflix provides its justification for such treatment in its critical accounting policy note *(see sidebar)*.

To Netflix's credit, it goes so far as to point out the differing treatment from its peers; however, such clear disclosure is not always the case. Curiously, this classification contrasts with its own classification of cash paid for its streaming content library, which it classifies as an operating activity—a difference that the notes to the financial statements do not reconcile.

**Table 4 | Diamond Foods, Inc. Consolidated Statements Of Cash Flows ($000s)**

| | —Year ended July 31— | | |
|---|---|---|---|
| **Cash flows from operating activities** | **2013** | **2012** | **2011** |
| Net income (loss) | ($163,232) | ($86,336) | $26,567 |
| **Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities** | | | |
| Depreciation and amortization | 33,525 | 28,347 | 28,116 |
| Deferred income taxes | (11,412) | 8,661 | (10,532) |
| Excess tax benefit from stock option transactions | — | — | (1,447) |
| Stock-based compensation | 4,229 | 9,206 | 7,687 |
| Loss on warrant | 11,326 | 10,360 | — |
| Securities settlement | 96,129 | — | — |
| Debt issuance costs amortization | 3,393 | 6,437 | 1,749 |
| Payment-in-kind interest on debt | 24,526 | 3,134 | — |
| Gain on separation and clawback agreement | (3,173) | | |
| Write off of acquisition costs | — | 6,406 | — |
| Impairment of equipment | — | 10,132 | — |
| Impairment of intangible asset | 37,560 | — | — |
| Other, net | 1,869 | 952 | 1,055 |
| **Changes in assets and liabilities:** | | | |
| Trade receivables, net | (13,077) | 12,034 | (32,875) |
| Inventories | 50,123 | (12,330) | (7,703) |
| Prepaid expenses and other current assets and income taxes | 7,929 | 8,499 | (11,316) |
| Other assets | 2,821 | (9,338) | (141) |
| Accounts payable and accrued liabilities | (10,091) | 8,652 | 38,178 |
| Payable to growers | (27,620) | (42,984) | 20,195 |
| Other liabilities | (564) | (8,123) | 7,158 |
| Net cash provided by (used in) operating activities | 44,261 | (46,291) | 66,691 |

## Content Library

The Company acquires DVD content for the purpose of renting such content to its members and earning membership rental revenues, and, as such, the Company considers its direct purchase DVD library to be a productive asset. Accordingly, the Company classifies its DVD library in "Non-current content library," net, on the Consolidated Balance Sheets. The acquisition of DVD content library, net of changes in related liabilities, is classified within cash used in investing activities on the Consolidated Statements of Cash Flows because the DVD content library is considered a productive asset. Other companies in the in-home entertainment video industry classify these cash flows as operating activities.

Although some may be critical of Netflix's decision to classify the DVD library activity as investing, the company is simply interpreting the malleable FASB guidance differently. Interestingly, IFRS requires such activity to be classified as an operating activity.

In our view, such activity is essential to these entities' operations and more akin to the purchase of inventory. Therefore, to address this disparity in treatment, we make an analytical adjustment to put these issuers on equal footing by reclassifying Netflix's cash outflows as an operating activity.

This is a fairly straightforward example of disparate treatment of similar transactions. However, other more complex and less obvious issues exist. One such area is differences in the classification of cash paid for interest.

## Conflict of interest

U.S. GAAP requires "cash payments to lenders and other creditors for interest" to be reported as cash outflows from operating activities. Unfortunately, for certain types of debt instruments, strictly due to their form and the mechanical approach to the statement of cash flows, cash paid for interest is reported elsewhere in the statement. This can skew the comparability of operating cash flows between peer companies with different types of instruments.

The most common occurrence of this phenomenon is when debt is issued at a discount, including convertible debt when split accounting is applied. Probably the most straightforward example is a zero-coupon bond. By definition, there are no coupon interest payments with zero-coupon bonds. The interest on the bond is paid at maturity, represented by the difference between the amount repaid at maturity and the amount received at issuance. Therefore, over the term of the instrument, the issuer reports no cash paid for interest and must determine the appropriate classification of the amount it pays at maturity (or the amount it pays to repurchase the debt if it calls the debt prior to maturity).

As noted, ASC 230 requires that cash flows be classified depending on the

**Table 5 | Chesapeake Energy Corp Consolidated Statements Of Cash Flows (Mil. $)**

| | —Year ended Dec. 31— | | |
|---|---|---|---|
| **Cash flows from operating activities** | **2012** | **2011** | **2010** |
| Net income (loss) | ($594) | $1,757 | $1,774 |
| **Adjustments to reconcile net income (loss) to cash provided by operating activities** | | | |
| Depreciation, depletion and amortization | 2,811 | 1,923 | 1,614 |
| Deferred income tax expense (benefit) | (427) | 1,110 | 1,110 |
| Unrealized (gains) losses on derivatives | (567) | 796 | 592 |
| Stock-based compensation | 120 | 153 | 147 |
| Gains on sales of fixed assets | (267) | (437) | (137) |
| Impairments of fixed assets and other | 316 | 46 | 21 |
| Impairment of natural gas and oil properties | 3,315 | — | — |
| (Gains) losses on investments | 164 | (41) | (107) |
| Gains on sales of investments | (1,092) | — | — |
| Impairment of investments | — | — | 16 |
| Losses on purchases or exchanges of debt | 200 | 5 | 29 |
| Other | 74 | (3) | 110 |
| Increase in accounts receivable and other assets | (68) | (530) | (769) |
| Increase (decrease) in accounts payable, accrued liabilities and other | (1,148) | 1,124 | 717 |
| Cash provided by operating activities | 2,837 | 5,903 | 5,117 |
| **Cash flows from investing activities** | | | |
| Drilling and completion costs | (8,930) | (7,467) | (5,242) |
| Acquisitions of proved and unproved properties | (3,161) | (4,974) | (6,945) |
| Proceeds from divestitures of proved and unproved properties | 5,884 | 7,651 | 4,292 |
| Additions to other property and equipment | (2,651) | (2,009) | (1,326) |
| Proceeds from sales of other assets | 2,492 | 1,312 | 883 |
| Proceeds from (additions to) investments | (395) | 101 | (134) |
| **Cash flows from operating activities** | | | |
| Proceeds from sale of midstream investment | 2,000 | — | — |
| Acquisition of drilling company | — | (339) | — |
| Increase in restricted cash | (222) | (44) | — |
| Other | (1) | (43) | (31) |
| Cash used in investing activities | (4,984) | (5,812) | (8,503) |
| **Cash flows from financing activities** | | | |
| Proceeds from credit facilities borrowings | 20,318 | 15,509 | 15,117 |
| Payments on credit facilities borrowings | (21,650) | (17,466) | (13,303) |
| Proceeds from issuance of term loans, net of discount and offering costs | 5,722 | — | — |
| Proceeds from issuance of senior notes, net of discount and offering costs | 1,263 | 1,614 | 1,967 |
| Proceeds from issuance of preferred stock, net of offering costs | — | — | 2,562 |
| Cash paid to purchase debt | (4,000) | (2,015) | (3,434) |
| Cash paid for common stock dividends | (227) | (207) | (189) |
| Cash paid for preferred stock dividends | (171) | (172) | (92) |
| Cash (paid) received on financing derivatives | (37) | 1,043 | 621 |
| Proceeds from sales of noncontrolling interests | 1,077 | 1,348 | — |

**Table 5 | Chesapeake Energy Corp Consolidated Statements Of Cash Flows (Mil. $)** (continued)

| | —Year ended Dec. 31— | | |
|---|---|---|---|
| **Cash flows from financing activities** (continued) | **2012** | **2011** | **2010** |
| Proceeds from other financings | 257 | 300 | — |
| Distributions to noncontrolling interest owners | (218) | (9) | — |
| Net increase (decrease) in outstanding payments in excess of cash balance | (172) | 353 | 20 |
| Other | (79) | (140) | (88) |
| Cash provided by financing activities | 2,083 | 158 | 3,181 |
| Net increase (decrease) in cash and cash equivalents | (64) | 249 | (205) |
| Cash and cash equivalents, beginning of period | 351 | 102 | 307 |
| Cash and cash equivalents, end of period | $287 | $351 | $102 |

**Table 6 | Group 1 Automotive Inc. And Subsidiaries Consolidated Statements Of Cash Flows ($000s)**

| | —Year ended Dec. 31— | | |
|---|---|---|---|
| **Cash flows from operating activities** | **2012** | **2011** | **2010** |
| Net income | $100,209 | $82,394 | $50,304 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | | |
| Depreciation and amortization | 31,534 | 27,063 | 26,455 |
| Deferred income taxes | 13,282 | 24,824 | 23,274 |
| Asset impairments | 7,276 | 4,805 | 10,840 |
| Stock-based compensation | 11,931 | 10,919 | 9,942 |
| Amortization of debt discount and issue costs | 12,990 | 11,990 | 10,322 |
| Loss on redemption of long-term debt | — | — | 3,872 |
| (Gain) loss on disposition of assets | (4,941) | (961) | 848 |
| Tax effect from excess stock-based compensation | (2,875) | (2,478) | (592) |
| Other | 3,965 | 2,755 | 1,416 |
| **Changes in operating assets and liabilities, net of effects of acquisitions and dispositions** | | | |
| Accounts payable and accrued expenses | 29,874 | 77,027 | 16,130 |
| Accounts and notes receivable | (6,777) | (17,875) | (13,844) |
| Inventories | (278,232) | (7,410) | (174,249) |
| Contracts-in-transit and vehicle receivables | (29,091) | (53,821) | (27,218) |
| Prepaid expenses and other assets | 2,448 | (11,246) | 6,922 |
| Floorplan notes payable—manufacturer affiliates | 33,248 | 52,757 | (10,580) |
| Deferred revenues | (163) | (1,427) | (2,308) |
| Net cash provided by (used in) operating activities | (75,322) | 199,316 | (68,466) |
| **Cash flows from investing activities** | | | |
| Cash paid in acquisitions, net of cash received | (177,956) | (159,597) | (34,693) |
| Proceeds from disposition of franchises, property and equipment | 39,197 | 6,039 | 46,179 |
| **Cash flows from operating activities** | **2012** | **2011** | **2010** |
| Purchases of property and equipment, including real estate | (88,491) | (60,558) | (69,116) |
| Other | 2,792 | 1,343 | 2,843 |
| Net cash used in investing activities | (224,458) | (212,773) | (54,787) |

activity that is likely to be the predominant source of cash flows. However, we believe there is a difference between singular cash flows that have characteristics of multiple categories and those that clearly contain two distinct elements with different characteristics.

In the case of a zero-coupon, the repayment at par contains two elements: the repayment of the amount borrowed and the payment of interest. Yet issuers routinely either overlook the principle (perhaps intentionally) that interest is an operating activity, or improperly rely on the singular cash flow notion and classify the full repayment as a financing activity, which leads to an overstatement of cash flow from operations.

We believe IFRS is more developed in this regard. IFRS allows for individual transactions to be bifurcated and classified separately. In fact, IAS 7 provides an example of this very scenario: a cash repayment of a loan, including both interest and principal elements.

Payment-in-kind (PIK) debt is another example in which companies can understate cash paid for interest. With PIK debt, issuers will settle periodic coupon interest via the issuance of additional "in-kind" debt, increasing the amount of the obligation by the amount of the unpaid interest and deferring payment until maturity. These periodic noncash settlements of interest are excluded from the body of the statement of cash flows and instead disclosed as noncash transactions. Since interest expense enters into the determination of net income, companies add back the PIK interest expense to arrive at cash flows from operating activities, as in the example of Diamond Foods Inc. (B-/Stable/—; *see table 4*).

At settlement of the debt, issuers usually report the full repayment (including the settlement of the paid-in-kind interest) as a financing activity. Similar to zero-coupon bonds, this approach does not reduce cash flow from operations for the payment of interest.

We see two potential solutions to this problem. One is to look at the nature of the original transaction to determine classification of the ultimate outflow, which, at a minimum, would reduce operating cash flows in the period of settlement. This approach is not without precedent: the FASB already applies this approach to cash receipts on long-term notes receivable from customers arising from the sale of goods and services and to cash payments on long-term notes payable to suppliers for the purchase of materials for manufacturing or goods for resale. In these instances, the FASB requires the ultimate cash flows to be classified as cash flows from operating activities, despite the fact that the payment is for the repayment of a debt obligation.

A second solution, which would actually reduce operating cash flows over the life of the instrument as the interest was paid-in-kind, would involve the inclusion of noncash activity within the body of the statement *(see the "Cash is cash, right?" section)*.

**Derivatives and hedging**

The area of accounting that perhaps best exemplifies the disparity in attention that the statement of cash flows receives relative to the other financial statements is derivatives and hedging. Volumes of accounting literature exist on how companies are to account for derivatives and hedging activity in the balance sheet and income statement, yet little of this guidance applies to the statement of cash flows. As a result, users of financial statements often find it difficult to discern the amount and location of this activity when analyzing the statement.

Even in instances where the FASB has provided explicit guidance on the treatment of derivatives in the statement of cash flows, we believe there is room for improvement. For example, U.S. GAAP states that each cash receipt or payment related to a derivative instrument should be classified according to its nature, without regard to whether it is a hedge of another item. An exception to this rule is provided such that the cash flows from a derivative accounted for as a hedge of another item may be classified in the same category in the statement of cash flows as the cash flows of the hedged item, so long as the derivative instrument does not include an "other-than-insignificant financing element" and that the accounting policy is disclosed.

The problem is that it has become customary for issuers to classify the cash flows of the hedging instrument in the same category as the hedged item (i.e., the exception has become the norm). Therefore, if a company chooses to classify the cash flows of the hedging instrument according to its own nature (what is now the exception) instead of consistent with the hedged item (which has become the norm), it is not explicitly required to draw attention to this anomalous treatment via disclosure (notwithstanding the policy disclosure requirements of ASC 235-10-50 "Notes to Financial Statements").

IFRS, in this case, leaves nothing to chance. It requires that the cash flows of a hedging instrument be classified in the same manner as the cash flows of the hedged item—a treatment to which we subscribe. If the FASB were not to follow the IASB's approach, it should, at a minimum, require disclosure regardless of the policy elected, in our view.

Another example of derivative-related cash flow statement confusion is when a derivative instrument, at inception, contains an "other-than-insignificant financing element." This can occur if the instrument includes off-market terms or requires an up-front cash payment. Despite there being two cash flow elements under such arrangements (a borrowing and a hedge), the FASB chose to avoid the complexity of splitting the cash flows due to cost-benefit concerns (even though complexity abounds on the balance sheet and income statement when it comes to derivatives). Instead, the FASB requires all cash inflows and outflows associated with the derivative to be classified as financing activities.

Contrary to its own principle, which directs companies to classify cash flows based on their "predominant source," the FASB set the bar very low ("other-than-insignificant") for classifying all cash flows related to a derivative as financing when there is an embedded financing element. By prohibiting bifurcation and applying such a low threshold, this approach can misstate the cash flow subtotals in circumstances where the majority of cash flows would not otherwise be classified as a financing activity *(see Chesapeake Energy Corp. BB-/Positive/—, table 5)*.

Based on Chesapeake Energy's notes to its financial statements, this classification is being mandated under this "other-than-insignificant financing element" provision, and it is not due to a policy election. Unfortunately, it is impossible to discern what cash flows are truly financing in nature and how much would otherwise be classified as operating, absent the financing element. Similar to the zero-coupon bond issue, this is an area that we believe could benefit from the separation of individual cash flows into their component parts, as well as clearer disclosures.

**Cash is cash, right?**

The issues that we have noted so far deal with the classification of actual cash flows within the statement. However, there are certain transactions where recognition, rather than classification, is the issue.

ASC 230 defines cash as both "currency on hand" and "demand deposits with banks." All charges and credits to such bank accounts represent cash flows that companies are to report in the statement of cash flows. There are certain types of transactions that, while they result in assets or liabilities on the balance sheet, do not result from direct or immediate cash receipts or cash payments and, therefore, are excluded from the statement of cash flows. Instead, U.S. GAAP requires that information about these "noncash" transactions be disclosed either in a narrative or summarized in a schedule.

The problem with doing this is that the exclusion of noncash transactions from the statement can distort the cash flow subtotals (e.g., the PIK interest example that we noted earlier). Further, the extent and transparency of disclosure associated with these transactions vary, making analysis difficult.

Table 6 | **Group 1 Automotive Inc. And Subsidiaries Consolidated Statements Of Cash Flows ($000s)** (continued)

| Cash flows from financing activities | —Year ended Dec. 31— 2012 | 2011 | 2010 |
|---|---|---|---|
| Borrowings on credit facility—Floorplan Line | 5,700,108 | 4,825,956 | 4,994,980 |
| Repayments on credit facility—Floorplan Line | (5,453,148) | (4,777,442) | (4,854,459) |
| Borrowings on mortgage facility | 18,080 | — | — |
| Principal payments on mortgage facility | (2,406) | (1,599) | (150,127) |
| Proceeds from issuance of 3.00% convertible notes | — | — | 115,000 |
| Debt issue costs | — | — | (3,959) |
| Purchase of equity calls | — | — | (45,939) |
| Sale of equity warrants | — | — | 29,309 |
| Redemption of other long-term debt | — | — | (77,011) |
| Borrowings of other long-term debt | 275 | 308 | 5,114 |
| Principal payments of long-term debt related to real estate loans | (15,197) | (7,775) | (3,806) |
| Borrowings of long-term debt related to real estate loans | 70,685 | 32,713 | 146,003 |
| Principal payments of other long-term debt | (4,784) | (3,293) | (1,021) |
| Repurchases of common stock, amounts based on settlement date | (11,317) | (50,777) | (26,765) |
| Issuance of common stock to benefit plans, net of employee net share settlements | (915) | (709) | 4,369 |
| Debt extinguishment costs | — | — | (177) |
| Tax effect from excess stock-based compensation | 2,875 | 2,478 | 592 |
| Dividends paid | (13,433) | (11,211) | (2,393) |
| Net cash provided by financing activities | 290,823 | 8,649 | 129,710 |

Table 7 | **Differences In Classification Between U.S. GAAP And IFRS**

| Cash Flow Item | U.S. GAAP Classification | IFRS Classification |
|---|---|---|
| Interest paid | Operating | Operating or financing |
| Interest received | Operating | Operating or investing |
| Dividends paid | Financing | Operating or financing |
| Dividends received | Operating | Operating or investing |
| Taxes paid | Operating | Operating, unless specifically identifiable with investing or financing activity |
| Cash flow with multiple elements | Must classify entire cash flow based on the activity that is likely to be the predominant source of cash flows, unless there is an other-than-insignificant financing element in which case the entire cash flow shall be classified as a financing activity | May classify the multiple elements differently |
| Cash payments to manufacture or acquire assets held for rental | Operating or investing | Operating |
| Cash flows of hedging instrument | Either classify based on the nature of the hedging instrument or in the same location as the hedged item, unless there is an other-than-insignificant financing element in which case the entire cash flow shall be classified as a financing activity | Must be classified in same manner as hedged item |

One of the most common noncash transactions occurs when a company enters into a capital lease whereby it records an asset along with an associated lease obligation (such transactions should become even more prevalent following the adoption of the proposed leasing standard, as more leases will receive on-balance-sheet treatment). In our view, a capital lease is effectively seller-financing for the purchase of an asset. Since the seller provides the financing and, thus, no cash is technically exchanged, the initial lease of an asset is treated as a noncash transaction under U.S. GAAP. Yet a company that receives third-party financing and purchases the same asset would report the receipt of proceeds (a financing activity) and subsequent payment to the equipment seller (an investing activity) on a gross basis in the statement of cash flows. In our view, these are economically similar transactions that receive markedly different treatment in the statement of cash flows simply because of their form.

When analyzing companies in lease-intensive sectors we look through the form of the transaction and, on a supplemental basis, adjust capital expenditures for the noncash purchase of capital assets to compare companies' lease and purchase decisions. We essentially apply the notion of constructive receipt and disbursement, and we include the noncash transaction in the body of the statement *(see "Corporate Methodology: Ratios And Adjustments")*. Although such an approach may seem somewhat inconsistent with the notion of a "cash flow" statement, this was actually one of the acceptable approaches for disclosing noncash transactions that the FASB proposed in the original FAS 95 (now ASC 230) exposure draft.

While ASC 230 explicitly excludes noncash transactions from the statement of cash flows, there are exceptions in practice. The automotive retailing sector provides an example. Automotive retailers historically financed the purchase of vehicles via floor-plan financing arrangements with the captive finance arms of the original equipment manufacturers

(OEMs). As the retailers achieved the requisite scale, they gained access to third-party financing supplied by bank syndicates or other third parties. Because this third-party floor plan financing was substantively the same as the financing received from the captive finance arms of the OEMs, the retailers did not originally differentiate the cash flows received from, or paid to, these third parties from cash flows received from, or paid to, the captive finance companies (i.e., all cash flows were reported within cash flows from operating activities).

In 2005, the SEC took up this issue and concluded that this third-party floor-plan financing met the definition of a financing activity and did not qualify for net reporting in operating. However, there was one problem: The purchase of the vehicles was, by definition, a noncash transaction because funds were transferred directly to the OEM from the third-party financier. This was not an issue when both sides of the transaction were included in operating activities (both the borrowing and the purchase) and only became a problem when the SEC required that the borrowing be presented as a financing activity. Although it is not clear from its comment letters, the SEC presumably realized how distortive this would be and, despite the noncash nature of the transaction, required it to be shown gross, as if cash had been received and disbursed *(see Group 1 Automotive Inc., BB+/Stable/—, table 6)*.

If Group 1 did not include the noncash purchase of the inventory within the body of the statement (the $5.7 billion of constructive receipts of proceeds are shown under financing activities, while the constructive disbursements for inventory are netted in the "Inventories" line under operating activities), the company would have reported net cash provided by operating activities of $5.6 billion in 2012. Obviously, this would not have been a fair depiction of their operating cash flows. Although this is an extreme example, it illustrates the merits of including noncash activity within the body of the statement.

Unfortunately, this is one area that is probably not going to benefit from the Financial Statement Presentation project. As currently proposed, the project would likely exacerbate this issue by excluding cash equivalents from the amounts to be reconciled, thereby creating the potential for even more noncash transactions.

## U.S. GAAP/IFRS Differences

Global capital market participants may utilize financial reports under various accounting regimes and should be aware of the potential differences resulting from distinctions between accounting frameworks.

The FASB and the IASB have worked together to reduce these differences on several fronts; however, the shelving of the Financial Statement Presentation project halted progress on the convergence of the statement of cash flows. While we present IFRS as an alternative in certain cases, it is not a panacea. For instance, IFRS provides optionality in the presentation of interest, taxes, and dividends. In the meantime, we provide a brief summary of some of the more common statement of cash flow differences between the two accounting regimes *(see table 7)*.

## In The Absence Of Comparability, Adjustments Remain Necessary

To maintain the comparability of corporate credit ratings, we will continue to make adjustments for inconsistent approaches to statements of cash flows within industries and sectors. But the long-term solution, in our view, would be stronger and more consistent guidance from the accounting standard setters, such as the FASB and the IASB. The issues we have observed illustrate the need for change. **CW**

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# Inconsistent Reporting Of Exceptional Items Can Cloud Results At Nonfinancial FTSE 100 Companies

## Overview

- Companies' reported underlying earnings (or other adjusted profit measure) can often give investors a misleading impression of their performance.
- In our study of nonfinancial FTSE 100 companies' most recent four years of financial reporting (as of Jan. 20, 2014), companies identify reconciling items that boost their own adjusted profit figures more often than items that decrease them. Indeed, adjusted operating profit exceeded the unadjusted operating profit in 73% of cases.
- The aforementioned finding is in part a result of the systematic exclusion of certain cost items from many companies' adjusted performance measures, the most common being impairments and the amortization of certain intangible assets.
- So-called exceptional restructuring costs can appear year after year for certain companies. In such cases, restructuring costs are often unavoidable because of the need to update operations to remain competitive.
- Twenty-one companies in our sample excluded restructuring charges from their measure of underlying earnings (or other adjusted profit measures), despite having restructuring charges in each of the last four years of financial reporting.
- Eighty-nine percent of companies present some form of adjusted profit measure in the most recent period, whether on the face of the income statement, in the notes to the financial statements, or in management's discussion and analysis of the annual report.
- In our opinion, more prescriptive and specific guidance is required for auditors to assist them as they scrutinize underlying earnings and exceptional items. Where such financial metrics are disclosed, we would prefer them to be incorporated into the financial statements to elevate the level of audit assurance.

The presentation of "underlying profit" can have a big influence on how successful a company appears to investors and other users of financial statements. Yet such presentation is often based on the subjective view of management, who can choose to omit certain "exceptional" accounting items such as restructuring costs. The net result is that a company's profitability can appear higher than is the case when reporting under International Financial Reporting Standards (IFRS).

In our view, investors and other users of financial information should exercise professional skepticism and carefully scrutinize underlying earnings and exceptional items before reaching their own view of a company's performance. What's needed, believes Standard & Poor's Ratings Services, are improved company disclosures; more prescriptive and specific guidance for auditors; and greater auditor assurance of underlying earnings and exceptional items.

Last year, we published a report examining alternative performance measures, such as operating profit excluding exceptional items, disclosed by a random sample of 10 nonfinancial Financial Times Stock Exchange (FTSE) 100 companies *(see "How Exceptional Accounting Items Can Create Misleading Earnings Metrics," published Feb. 20, 2013, on RatingsDirect)*. We identified a number of accounting trends that, in our view, could impede investors from gaining a clear and objective view of a company's earnings. Following the publication of this report, we were encouraged to see the Financial Reporting Review Panel of the Financial Reporting Council (FRC) outline specific recommendations on exceptional items. More recently, on Feb. 13, 2014, the European Securities and Markets Authority launched a consultation on guidelines on alternative performance measures.

Given the welcome enhanced scrutiny on this topic, and to gain further insight into companies' treatment of exceptional accounting items, we have conducted a more extensive study. This study examines the past four years of annual reports of the entire population of 82 nonfinancial companies in the FTSE 100 index *(see note 1)*. Here, we explain the analytical adjustments we may make to reported financial statements of corporate entities to derive the key financial metrics that we use in our analysis, adjustments that may differ from individual company management's views. In addition, we outline developments in related guidance applicable to companies, and enhancements we would like to see in the audit.

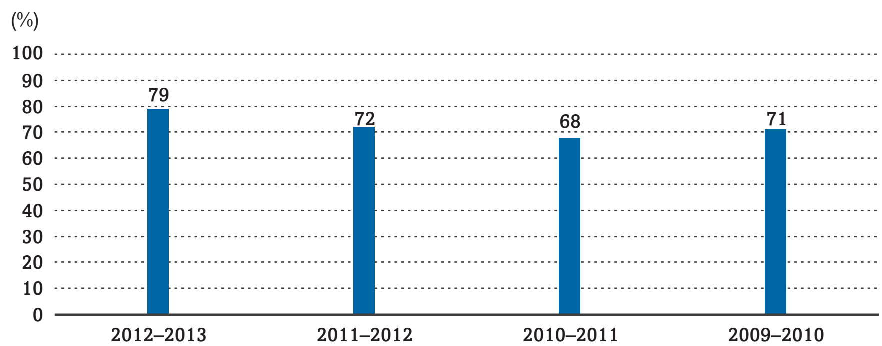
## A Subjective View Of Performance

Companies reporting under IFRS frequently separate exceptional or special items they believe are non-operating or nonrecurring to produce underlying or adjusted earnings information that purports to better reflect business performance. However, in our view, taking underlying earnings without understanding the nature of the exceptional items that a company has excluded can sometimes give a misleading picture of its earnings and future performance. The separation of exceptional or special items that companies consider are nonrecurring or non-operating in nature can lead users of financial statements to focus on companies' subjective, adjusted profit measures, rather than on the unadjusted, audited figures that the International Accounting Standards Board mandates companies to disclose. Our published criteria sets out the principles we use to determine whether specific transactions might be considered to be non-operating or nonrecurring when calculating our own adjusted metrics. *(For more details, see "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013.)*

## Company-Adjusted Operating Profit Presents A Brighter Picture

For each of the 82 nonfinancial FTSE 100 companies in our sample, we examined the four most recent annual reporting periods up to Jan. 20, 2014, to assess whether the companies' adjusted operating profit (or other similarly named financial metric) was higher or lower than the company's reported operating profit based on IFRS *(see note 2)*. We found that in each year of the four years surveyed, a majority of companies presented adjusted operating profit greater than the IFRS operating profit figure, 73% on average *(see chart)*. Moreover, 43 companies presented adjusted operating profit that was

### Percentage Of Companies Reporting Adjusted Operating Profit Greater Than IFRS Operating Profit




IFRS–International Financial Reporting Standards.
*Source: Standard & Poor's.*


### Table 1 | Unilever PLC Restructuring Costs 2008 To 2011

| (Mil. €) | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|
| Restructuring costs | 612 | 589 | 897 | 868 |
| Operating profit | 6,433 | 6,339 | 5,020 | 7,167 |
| Restructuring costs/operating profit (%) | 10 | 9 | 18 | 12 |

*Source: Unilever PLC.*

### Table 2 | Unilever PLC Underlying Operating Profit For 2011

| As originally disclosed in 2011 financial statements | 2011 (mil. €) |
|---|---|
| Operating profit | 6,433 |
| Restructuring costs | 612 |
| Business disposals | (221) |
| Acquisition and integration costs and other one-off items | 77 |
| Underlying operating profit | 6,901 |

*Source: Unilever PLC.*

greater than the IFRS operating profit in every one of the four years that we analyzed *(see table 4)*.

### Cost items such as impairment charges and the amortization of acquired intangibles are systematically excluded

A key factor behind these higher adjusted profits is that most companies define their adjusted profit measures to systematically exclude certain cost items that reduce the operating profit measured under IFRS. The most common cost items excluded are long-term asset impairments and the amortization of certain intangible assets, with 58 companies in our sample adjusting for impairments and/or intangible amortization in at least one of the four years that we examined.

Long-term asset impairments, such as goodwill impairments, tend to be large and irregular in nature and not reflective of ongoing period-to-period costs. Therefore, because of the size and volatility of impairments, there is often sound justification for management to exclude these items from its own measures of ongoing business performance. Indeed, in our credit analysis, we generally exclude impairment charges on long-life assets from our measure of earnings before interest and taxes (EBIT; which is broadly equivalent to operating profit) if they are large and irregular. Excluding a nonrecurring impairment from EBIT produces a better estimate of a company's ongoing profitability. However, this 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 and may also call into question the quality of previous investment or acquisition decisions.

Thirty-four companies in our sample excluded the amortization of certain intangible assets (often acquired intangible assets) from their adjusted profit measures. However, there is surprisingly little explanation given by companies as to why they considered this exclusion appropriate. Some arguments that we've generally observed within the financial reporting community (not necessarily by our sample of companies) are that:

- The amounts of amortization are inconsistent in timing and frequency and are significantly affected by the timing and size of acquisitions.
- The determination of the amounts of acquired intangibles is largely outside of management's control.
- The amortization expense does not result in ongoing cash expenses.
- Providing a supplemental measure that excludes these charges allows users of financial statements to evaluate results as if intangible assets had been developed internally rather than acquired.

*Investors and other users of financial information should exercise professional skepticism and carefully scrutinize underlying earnings and exceptional items…*

We do not find such arguments to be persuasive. In our corporate credit analysis, we do not generally exclude the amortization of acquired intangibles from our measure of EBIT. In our view, they represent a company's income statement recognition of earlier capital expenditures and therefore should meaningfully depress EBIT.

### So Called One-Off, Non-Operating Restructuring Costs Can Reappear Year After Year

In our initial report last year, we discussed the fact that Unilever PLC separately identified and disclosed restructuring costs alongside business disposals, impairments, and other one-off items, which were excluded from its measure of underlying operating profit. This implied to us that the restructuring costs were themselves nonrecurring or non-underlying in nature—despite the fact that Unilever identified significant restructuring costs in each of the four successive years of financial reporting from 2008 to 2011 *(see tables 1 and 2)*.

Following the publication of that article, we were encouraged to see that in Unilever's 2012 financial statements, restructuring costs were not separately disclosed in such a way on the income statement, or excluded from the calculation of the company's core operating profit (Unilever's revised alternative profit measure, replacing underlying operating profit; *see table 3)*. We believe that by including ongoing restructuring costs in its adjusted operating profit measure, Unilever is now providing a more meaningful depiction of its ongoing business performance.

Nonetheless, companies we sampled in the FTSE 100 still treat restructuring costs as exceptional (or otherwise adjusting) items, despite the fact that they reappear year after year. Indeed, 21 companies presented restructuring charges as exceptional items in each of the four financial years that we analyzed in our study *(see table 5)*.

By definition, we include restructuring costs in our calculation of EBITDA. Most companies need to restructure their operations at some point to improve productivity levels, as the global economy is constantly evolving and most businesses must alter or refocus their operations to remain competitive and viable. Although we may make analytical adjustments for what we view as truly nonrecurring items, these adjustments are generally limited to the extent that there has been some transformative change in a company's business. The relative stability or volatility of a company's earnings and cash flow is an important measure of credit risk that's embedded in our corporate criteria *(see "Corporate Methodology," published Nov. 19, 2013)*.

### Accounting Standards Allow Flexibility In Disclosure

International Accounting Standard 1 Presentation of Financial Statements (IAS 1) provides IFRS guidance explaining that companies can present additional subtotals (on the face of the income statement, for example) where relevant to better understand the company's financial performance. IAS 1 also provides examples of the circumstances that would give rise to the separate disclosure of income and expense items. IAS 1 leaves considerable scope for interpretation, which is one reason companies adopt different approaches to excluding exceptional items to determine underlying earnings. In our view, given the principle-based nature of IAS 1, companies should provide qualitative, and where practicable, quantitative disclosures regarding:

- How management determined that the item was appropriate for exclusion from underlying earnings or equivalent.
- What factors or criteria management consistently applies each year to charges and credits to decide that an item is not part of underlying earnings. From this disclosure, investors and other users of financial statements could independently assess management's judgment and assumptions to inform their view of whether an item is exceptional.
- Why management doesn't deem some ongoing costs as part of underlying earnings and instead identifies them as exceptions or special items for multiple annual periods—and as a result, removes them from their key financial statistics.
- Why a similar or identical item may change classification to or from exceptional from one year to another.
- The effect on prior-period amounts of significant changes in accounting estimates.

Table 3 | **Unilever PLC Core Operating Profit For 2011**

**As disclosed in 2012 financial statements**

| (Mil. €) | 2012 | 2011 |
|---|---|---|
| Operating profit | 6,989 | 6,433 |
| Acquisition and disposal-related cost | 190 | 234 |
| (Gain)/loss on disposal of group companies | (117) | (221) |
| Impairments and other one-off items | — | (157) |
| Core operating profit | 7,062 | 6,289 |

*Source: Unilever PLC.*

Table 4 | **FTSE 100 Companies Showing Greater Adjusted Operating Profit Than IFRS Operating Profit In Each Of The Past Four Financial Years**

| No. | Company | No. | Company |
|---|---|---|---|
| 1 | AMEC PLC | 22 | Intertek Group PLC |
| 2 | ARM Holdings PLC | 23 | Johnson Matthey PLC |
| 3 | Associated British Foods PLC | 24 | Meggitt PLC |
| 4 | AstraZeneca PLC | 25 | National Grid PLC |
| 5 | BAE Systems PLC | 26 | Reed Elsevier PLC |
| 6 | BG Group PLC | 27 | Rexam PLC |
| 7 | BT Group PLC | 28 | Rio Tinto PLC |
| 8 | Babcock International Group PLC | 29 | Sage Group PLC |
| 9 | British American Tobacco PLC | 30 | Severn Trent PLC |
| 10 | Bunzl PLC | 31 | Shire PLC |
| 11 | Capita PLC | 32 | Smith & Nephew PLC |
| 12 | Coca-Cola HBC AG | 33 | Smiths Group PLC |
| 13 | Compass Group PLC | 34 | Sports Direct International PLC |
| 14 | Diageo PLC | 35 | TUI Travel PLC (part of TUI AG) |
| 15 | Experian PLC | 36 | Tesco PLC |
| 16 | G4S PLC | 37 | Unilever PLC |
| 17 | GlaxoSmithKline PLC | 38 | Vedanta Resources PLC |
| 18 | Glencore International PLC | 39 | Vodafone Group PLC |
| 19 | IMI PLC | 40 | WPP PLC |
| 20 | ITV PLC | 41 | Weir Group PLC |
| 21 | Imperial Tobacco Group PLC | 42 | William Hill PLC |
| | | 43 | Wolseley PLC |

IFRS–International Financial Reporting Standards.
*Sources: Company annual reports.*

## Management Guidance Improves, But Guidance For Auditors Could Be Strengthened

In our February 2013 report, we recommended that "the FRC should provide more specific guidance to auditors as to the type of questions they should ask management and the factors they should consider when assessing whether the company's presentation of its financial accounts is properly representative." Although no such guidance for auditors has been provided, we were encouraged to see that in December 2013, the FRC issued a reminder to boards of directors of the need to improve the reporting of additional and exceptional items by companies and to ensure consistency in their presentation.

In particular, the Financial Reporting Review Panel of the FRC outlined a number of factors that companies should consider when judging what to include in underlying profit. For example, companies should have an even-handed approach in capturing gains and losses as exceptional items, with clear disclosures and consistency year after year. Companies should also consider whether recurring material items such as restructuring costs should be exceptional. Where significant items of expense are unlikely to be finalized for a number of years, or may subsequently be reversed, the income statement effect of such changes should be similarly identified as additional items in subsequent periods, and readers should be able to track movements in respect of these items between periods.

Furthermore, the FRC's latest revision of the UK Corporate Governance Code and consequential amendments to U.K. auditing standards aim to further increase confidence among users of financial statements in companies' annual reports and external audits. We agree with the FRC in calling for an explicit statement by a company's board of directors confirming that the entire annual report is "fair, balanced, and understandable" because in our view it provides an increased level of management accountability.

In our opinion, however, there should be more prescriptive and specific guidance for auditors to assist them as they scrutinize underlying earnings and exceptional items. When relevant disclosures such as those pertaining to exceptional items and underlying earnings are only in the management discussion and analysis section of an annual report, auditing standards merely require auditors to read this accompanying information to check that it's consistent with the knowledge they acquire in the course of performing the audit. However, if management incorporates exceptional items and underlying earnings into financial statements, then auditing standards require auditors to ensure that the financial statements give a "true and fair" view, which we believe is a more desirable level of audit assurance. That said, it is arguably difficult for auditors to assess what represents a "true and fair" view because of the scarcity of guidance in this area and the scope of interpretation afforded by IAS 1.

*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.*

## Standard & Poor's View On Non-Operating Items

Considering the potentially misleading and inconsistent reporting of exceptional items and adjusted profit measures, our starting point for analysis is the company's reported financial statements prepared in accordance with established accounting standards, such as IFRS or U.S. GAAP. We may make adjustments to those reported figures, but those adjustments will often differ from the adjustments identified by management.

We define our key income statement-based metrics earnings before interest, taxes, depreciation, and amortization (EBITDA), EBIT, and funds from operations (FFO) in a particular fashion. However, the reported financial statements often do not conform to our views of these metrics. Therefore, it is necessary for us to adjust the reported financial information to align with our methodology. Our decision to include or exclude an activity from a particular metric depends on whether we consider that activity to be operating or non-operating in nature. Independent of that decision, we also consider whether an activity is recurring or nonrecurring.

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.

Of course, if we believe that historical costs incurred by a company (such as restructuring costs) will not reoccur (or will reoccur at lower levels) in future years, we would build such an expectation into our forecasts of the company's future profitability and cash flow generation. Our credit ratings are forward-looking and future periods are generally more heavily weighted in our analysis and assessment of a company's cash flow leverage.

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 non-operating that is excluded from EBITDA.

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 non-operating.

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 cash flow from operations.

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. 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. We may, however, take an alternative view about the classification of transactions to those presented in the statement of cash flows, and this would flow through to our other metrics. Examples of how we apply this principle to various scenarios, together with other common items that companies may describe as "exceptional" are:

*Our definition of EBITDA aims to capture the results of a company's core operating activities…*

*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 a company's 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.

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 non-operating items.

*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.

*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's important to factor these expenses into our metrics.

*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.

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.

*Revaluation gains and losses in the real estate sector.* Where companies mark their properties to market on an ongoing basis (as under IFRS), we generally exclude the resulting unrealized revaluation gains and losses from

**Table 5 | FTSE 100 Companies Reporting Exceptional Restructuring Charges In Each Of The Past Four Financial Years**

| No. | Company | No. | Company |
|---|---|---|---|
| 1 | Anglo American PLC | 11 | Imperial Tobacco Group PLC |
| 2 | AstraZeneca PLC | 12 | Mondi PLC |
| 3 | BP PLC | 13 | National Grid PLC |
| 4 | BT Group PLC | 14 | Rexam PLC |
| 5 | British American Tobacco PLC | 15 | SABMiller PLC |
| 6 | Centrica PLC | 16 | Smith & Nephew PLC |
| 7 | Coca-Cola HBC AG | 17 | Smiths Group PLC |
| 8 | Diageo PLC | 18 | TUI Travel PLC |
| 9 | GlaxoSmithKline PLC | 19 | Tate & Lyle PLC |
| 10 | IMI PLC | 20 | Tesco PLC |
| | | 21 | United Utilities PLC |

*Sources: Company annual reports.*

our profitability and cash flow proxy measures. We believe that these unrealized gains and losses, while stemming from operating activities, result in distortions to the company's financial performance metrics. Nonetheless, we take account of the market factors that give rise to revaluation gains and losses—for example, in determining our forecast assumptions—because these can be important indicators of market trends.

*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.

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.

*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.

Currency transaction gains and losses may be viewed as operating or non-operating 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 non-operating. For example, we may adjust (or exclude) foreign currency gains or losses resulting from the issuance of foreign-currency-denominated debt.

## Progress, Then, But Full Comparability Is Still Some Way Off

The welcome enhanced regulatory scrutiny on adjusted earnings and exceptional items lead us to believe that we could be entering a new era of financial reporting in the U.K., with companies less likely to present (and auditors more ready to challenge) misleading underlying profit figures. Realistically, any such improvements will likely be gradual, and complete comparability in reporting or underlying earnings may still be some way off, if it ever becomes achievable at all. For this reason, in our opinion, investors and other users of financial statements should exercise professional skepticism and carefully scrutinize underlying earnings and exceptional items before reaching their own view of a company's performance. **CW**

### NOTES

1. Our study covers 81 listed nonfinancial FTSE 100 companies, but we analyze Glencore International PLC and Xstrata PLC separately.
2. Two companies in our sample, Carnival Corp. and Shire PLC, report under U.S. GAAP rather than IFRS. Operating profit is not defined under IFRS, but most companies nonetheless present it, or we were able to derive it.



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# Non-GAAP Measures Are Useful, But Could Benefit From Standard Definitions And Independent Assurances

Analytical use of supplementary financial measures or non-Generally Accepted Accounting Principles (GAAP) measures are increasingly popular among analysts and investors today. Many non-GAAP measures are widely reported by management—e.g., earnings before interest, taxes, depreciation and amortization (EBITDA), adjusted debt, and free cash flow (FCF). Such measures can give management and users of financial reports additional analytical insight into a company's performance and financial condition, expanding on the information stipulated by the GAAP framework. However, a major issue regarding non-GAAP measures is the lack of consistent definitions for their calculation and disclosure, even among companies in the same industry. The lack of standard definitions is one reason regulators have restricted the use of certain measures in financial statements and require extensive disclosure and reconciliations; also, non-GAAP measures are unaudited, and therefore subject to a lesser degree of independent assurance. This also opens a door for companies to adjust for items that they believe showcase better results and metrics—at times even if the adjustment does not belong in that metric. However, the widespread use of such measures—even with their inconsistencies—means financial statement users believe they have value.

Standard & Poor's Ratings Services focuses on management's reporting of two key non-GAAP measures from a credit perspective—adjusted debt, and free operating cash flow (FOCF) in the corporates industry. We discuss certain analytical adjustments we apply to GAAP information in the corporates industry (U.S. and Canadian companies), to derive our view of these analytically relevant financial measures.

## Non-GAAP Measures Are Inconsistent And Incomparable, But Have Hidden Value

Non-GAAP measures can involve complexity and subjectivity in their construction. They can range from a simple "earnings before income taxes" to more complex measures that are not defined by GAAP (e.g., "maintenance capital expenditure" in the telecommunications sector).

Non-GAAP financial measures generally include adjustments for items not specified by rules set out in the accounting framework, and so may not be defined and calculated with the same completeness and neutrality as a GAAP measure. In these circumstances, to be a faithful representation and one used internally by management, it should have the same components management uses; if the measure was requested by investors, it should have the components management believes investors need. The number of non-GAAP measures used by companies in their filings can be alarming: Barrick Gold Inc., a large Canadian mining company, provides approximately 19 different non-GAAP measures. This raises questions not only about the sheer volume of financial information provided to capital markets, but also about managements' intentions. We believe key non-GAAP measures that provide additional financial information regarding the underlying business operations can be useful. More information may be better than less, but only if it is relevant to the business.

## Inconsistencies Prevail Around Free Operating Cash Flow (FOCF)

We define FOCF as cash flow from operations (CFO) minus capital expenditures (plus or minus all applicable adjustments). CFO, also referred to as operating cash flow, is a measure that 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

**Table 1 | Free Cash Flow From Operations—Variations In The Metric**

| | Sysco Corp. (mil. $) | Monsanto Co. (mil. $) | Rockwell Automation Inc. (mil. $) | Nordstrom Inc. (mil. $) | Loblaw Companies Ltd. (mil. C$) |
|---|---|---|---|---|---|
| | See note (1) | See note (2) | See note (3) | See note (4) | See note (5) |
| **Net cash provided by operating activities** | **1,512** | **2,740** | **1,015** | **1,110** | **1,637** |
| Capital expenditures | (512) | — | (146) | (513) | (1,017) |
| Proceeds from sales of plant and equipment | 16 | — | — | — | — |
| Net cash required by investing activities | — | (777) | — | — | — |
| Excess income tax benefit from share-based compensation | — | — | 32 | — | — |
| Cash dividends paid | — | — | — | (220) | — |
| Change in credit card receivables | — | — | — | (42) | 204 |
| Change in cash book overdrafts | — | — | — | 5 | — |
| **Free cash flow** | **1,016** | **1,963** | **901** | **340** | **824** |
| **S&P's free cash flow from operations (unadjusted)** | **1,000** | **1,901** | **869** | **597** | **264** |

*(1) Source: 10-K for the year ended June 29, 2013. (2) Source: 10-K for the year ended Aug. 31, 2013. (3) Source: 10-K for the year ended Sept. 30, 2013. (4) Source: 10-K for the year ended Feb. 2, 2013. (5) Source: Annual report for the year ended Dec. 29, 2012.*

**Table 2 | Adjusted Debt—Inconsistent Adjustments**

| | | —Adjustment for— | | |
|---|---|---|---|---|
| **Company** | **Organization type** | **Operating lease commitments** | **Cash and cash equivalents** | **Fair value of derivatives** |
| Rock-Tenn Co. (a) | Paper/forest products | No | Yes | N/A (1) |
| Nordstrom Inc. (b) | Department stores | Yes | No | Yes (2) |
| Barrick Gold Corp. (c) | Mining | No | Yes | Yes (2) |
| Loblaw Cos. Ltd. (d) | Supermarkets | No | No | No (3) |
| Encana Corp. (e) | Oil and gas exploration and production | No | Yes | N/A (1) |

(1) The company did not report any derivatives related to debt in its financial statements. (2) The company adjusted for interest rate swaps. (3) The company reported interest rate swaps but did not adjust them with debt. N/A—Not applicable.
*(a) Source: 10-K for the year ended Sept. 30, 2013. (b) Source: 10-K for the year ended Feb. 2, 2013. (c) Source: Annual report for the year ended Dec. 31, 2012. (d) Source: Annual report for the year ended Dec. 29, 2012. (e) Source: Annual report for the year ended Dec. 31, 2012.*

paid or received, that a company reports as investing or financing cash flows. *(See "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013, on RatingsDirect.)*

We found a number of variations of this important metric used by companies in practice *(see table 1)* as compared to Standard & Poor's Ratings Services reported metrics (before our analytical adjustments).

Sysco Corp. not only subtracts capital expenditures from CFO to arrive at FOCF, but also sales proceeds from the sale of property, plant & equipment, thereby inflating its FCF by 1.6%.

Monsanto Co. deducts net cash used in investing activities (less than its capital expenditures) from CFO, also resulting in higher FCF (by 3.3%) than our computation of FOCF.

Rockwell Automation Inc. has an addition to cash flow from operations in "excess income tax benefit from share-based compensation," causing 3.7% higher FCF than our FOCF computation.

Nordstrom Inc. adjusts for items such as "cash dividends paid," "change in credit card receivables originated at third parties," and "change in cash book overdrafts" in addition to "capital expenditures." It is the only company in our sample that reported lower FCFD (by 43%) compared with our reported FOCF. However, Nordstrom's FCF measure is closely aligned with our discretionary cash flow measure, which also adjusts for cash dividends. This clearly shows the lack of standard definitions in the use of non-GAAP measures.

Loblaw Cos. Ltd. also adjusts for the net change in credit card receivables (a positive number). However, an adjustment for interest paid/received that is reported in cash flows for investing/financing activities (a negative number) is not adjusted ($356). The aggregate effect of these two items increased its FCF measure by $560 million, or 212%, compared with our reported FOCF.

## Adjusted Debt: Standard Definition Would Help

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—often contrary to the way in which they are reported by the company—-affects the quantification of debt and the earnings and cash flow measures used in our analysis, which is why it helps to understand the principles underpinning our adjustments to debt.

Items we generally 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).

Many of the items that increase debt when we apply our 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, because these are executory contracts (i.e., a counterparty must still perform an action and the benefits of ownership have yet to accrue to the company; *see "Corporate Methodology: Ratios And Adjustments"*).

We reviewed the adjusted debt measures for a sample of five companies from different corporate sectors, and noted inconsistencies in management's reporting of the adjusted debt non-GAAP measure *(see table 2)*.

- Operating lease commitments: Nordstrom Inc. was the only company that added operating lease commitments to debt (the calculation is based on eight months' rent expense, rather than the actual commitments). We treat operating and finance lease obligations as debt. Reclassifying operating leases as debt can 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 helps bring companies' financial ratios closer to the underlying economics, and make them more comparable by considering all of a company's financial obligations, on or off the balance sheet *(see "Corporate Methodology: Ratios And Adjustments")*.

- Cash and cash equivalents: All five companies had cash and cash equivalents on their balance sheets, but only three deducted it to arrive at adjusted debt. While the difference could

**Table 3 | Mining Industry**

| Barrick Gold Corp. (mil. $, except ounces sold)* | | Allied Nevada Gold Corp. (mil. $, except ounces sold)§ | | Hecla Mining Co. (mil. $, except ounces produced)§ | | Stillwater Mining Co. (mil. $)§ | |
|---|---|---|---|---|---|---|---|
| **Cost of sales** | **6,210** | **Total cost of sales** | **109** | **Total cash costs** | **17** | **Total operating costs (non-GAAP)** | **209** |
| Less: depreciation | 1,389 | Less: depreciation and amortization | (15) | Divided by silver ounces produced | 6 | Royalties, taxes, and other | 40 |
| **Cash cost of sales** | **4,821** | **Silver revenues** | **(22)** | **Total cash cost per silver ounce produced** | **3** | **Total cash costs (non-GAAP)** | **249** |
| Cost of sales applicable to discontinued operations | — | Total adjusted cash costs | 73 | Total cash costs | 17 | Asset-retirement costs | 1 |
| Cost of sales applicable to non-controlling interests | (168) | Gold ounces sold | 115 | Depreciation, depletion, and amortization | 44 | Depletion, depreciation, and amortization | 57 |
| Cost of sales applicable to ore purchase arrangement | (161) | Adjusted cash costs per ounce | 638 | Treatment costs | (73) | Depletion, depreciation, and amortization (in inventory) | 1 |
| Other metal sales | (139) | — | — | By-product credits | 191 | Total production costs (non-GAAP) | 308 |
| Realized non-hedge gains/ losses on fuel hedges | (9) | — | — | Change in product inventory | (1) | Change in product inventories | (3) |
| Treatment and refinement charges | 6 | — | — | Reclamation and other costs | 1 | Cost of PGM recycling | 335 |
| Impact of Barrick Energy | (90) | — | — | Cost of sales and other direct production costs and depreciation, depletion, and amortization (GAAP) | 178 | PGM recycling—depreciation | 1 |
| **Total cash cost of sales** | **4,260** | — | — | — | — | **Profit from PGM recyling** | **11** |
| Ounces sold—consolidated basis (000s ounces) | 7,465 | — | — | — | — | Profit from by-products | 31 |
| Ounces sold—non-controlling interest (000s ounces) | (173) | — | — | — | — | Total consolidated costs of revenues | 682 |
| **Ounces sold—equity basis (000s ounces)** | **7,292** | — | — | — | — | — | — |
| **Total cash costs per ounce** | **584** | — | — | — | — | — | — |
| **Total cash cost of sales** | **4,260** | — | — | — | — | — | — |
| General and administrative costs | 373 | — | — | — | — | — | — |
| Rehabilitation—accretion and amortization | 147 | — | — | — | — | — | — |
| Mine on-site exploration and evaluation costs | 156 | — | — | — | — | — | — |
| Mine development expenditures | 833 | — | — | — | — | — | — |
| Sustaining capital expenditures | 1,129 | — | — | — | — | — | — |
| **All-in sustaining cash costs** | **6,898** | — | — | — | — | — | — |
| Ounces sold—consolidated basis (000s ounces) | 7,465 | — | — | — | — | — | — |
| Ounces sold – non-controlling interest (000s ounces) | (173) | — | — | — | — | — | — |
| **Ounces sold – equity basis (000s ounces)** | **7,292** | — | — | — | — | — | — |
| **All-in sustaining cash costs per ounce** | **945** | — | — | — | — | — | — |

*Source: Annual report for the year ended Dec. 31, 2012. §Source: 10-K for the year ended Dec. 31, 2012.

potentially be a result of the use of the adjusted debt measure (the two companies that did not deduct it) as against net debt measure (the three companies that did), it also reflects a lack of consistency in definitions. Based on our corporate criteria, we may reduce the adjusted debt figure by netting surplus cash *(see "Corporate Methodology: Ratios And Adjustments")*.

- Fair value of derivatives: An adjustment that was more consistent across the sample of companies was the adjustment for fair value of derivatives: three of the five companies had derivative instruments related to long-term debt; two companies adjusted for it.

## There Is Some Standardization, But More Is Needed In the Mining Industry

We believe investors and analysts want more information about mining entities, because of the sector's unique performance metrics, particularly EBIT, EBITDA, various forms of adjusted profit (or underlying profit), and business performance measures. The lack of standard definitions results in variations in financial metric calculations by management, hindering analytical abilities.

Another common non-GAAP measure in the mining industry is cash costs, e.g., gold-mining companies often present the cash cost per ounce of gold produced. Mining analysts use cash costs as a key measure of a mining entity's performance. The general idea is that cash costs:

- Provide useful information about the efficiency of a mine and its position on the cost curve;
- Allow a mine to be benchmarked against others in the industry; and
- Help investors assess the mine's ability to generate cash at different commodity prices.

There are no standards for calculating or reporting cash costs across the industry as a whole *(see table 3)*.

There is, however, a voluntary industry practice for the reporting of cash costs for the mining industry—the key intention is to tabulate the costs of the mine on a per-unit of output basis; the standard is easily applied to other types of mining (not just gold).

- Because there is a voluntary standard in the mining industry, we found relatively greater consistency in the adjustments made by companies to arrive at cash operating cost per ounce. Items such as depreciation, depletion & amortization, by-product sales, treatment/refinement costs were adjusted by all the companies we reviewed.
- However, we also noted certain one-off adjustments, e.g., asset retirement costs (Stillwater Mining Co.), derivatives and inter-company charges (Barrick Gold), and workers' participation cost (Southern Copper Co.) While these items could also be a result of potential differences in business operations, we believe using a standardized definition and independent assurance of these measures could provide higher-quality analytical information, and greater comfort for users of non-GAAP measures.
- By-product revenue is a common item adjusted by the companies we reviewed. While this revenue is part of a company's overall business operations, it could add an element of volatility to the non-GAAP measure because it fluctuates based on price changes (as does revenue from the primary product), and affect the cost of the primary product. When the price of a by-product increases significantly, cash operating cost per ounce for the primary product could be lower than comparative periods (depending on the volume of by-products sold), or vice versa. While this is just one of the many data points in our analysis, we believe excluding by-product revenue is a more reasonable definition, and focuses the measure on the core operations of the company.

## Connecting The Dots: Different Perspectives On Non-GAAP Measures

### We believe there is a disconnect between the needs of companies and investors

Companies may prefer to report smoother results with less volatility, based on readily available historical information by using non-GAAP measures, but we believe financial statement users want to see the most current, relevant, reliable information and make their own decisions about whether to capture natural volatility that is present in the economics of a business.

### Is a company's growth story organic or not?

By removing amounts not considered by management to be core to its operations, the non-GAAP measure facilitates communication of the company's underlying operational performance. Non-GAAP measures help explain the perspective on business changes that are organic, rather than those that are unusual or infrequent, and sometimes provide insight into how a company manages and monitors its business. This information can be useful when forecasting future cash flows, but may not necessarily match the methodology investors and analysts use.

### Additional information is not always available in GAAP financial statements

Some non-GAAP metrics represent economic reality and reflect the underlying business better than GAAP measures. Non-GAAP measures may also provide more relevant information than is provided under GAAP. Companies often report items, such as operating earnings exclusive of non-recurring expense or revenue, funds from operations, adjusted debt, FCF and EBITDA to provide additional insight into their performance and also meet requirements of financial statement users. These supplemental non-GAAP measures are beneficial to analysis.

## Assurance On Non-GAAP Measures Will Enhance Analytical Value

We believe the current rules regarding the presentation, calculation and disclosure of non-GAAP measures are generally adequate *(see Appendix)*. In particular, we value the requirement that a non-GAAP measure must be defined, and that changes in its composition from year to year must be highlighted and explained; however, we are concerned with consistency in the definition of the measures. If regulators provide standard definitions for key non-GAAP measures, all analysis can benefit: We believe this will enhance consistency and comparability, and help rein in potential inappropriate use of non-GAAP measures.

We also believe there should be independent assurance concerning compliance with regulatory guidance on non-GAAP financial measures. It is important that the presentation of non-GAAP measures does not conflict with the financial reporting requirement of fair presentation. The reliability and consistency of these data are important to investors and analysts when analyzing individual company performance and across peers. We believe the scope of independent audits also should include procedures and assurance of non-GAAP measures. At a minimum, independent auditors should ensure the appropriateness and completeness of the items that companies adjust to derive non-GAAP measures and assurance on compliance with regulations. These steps likely will enhance comparability, consistency, and compliance, because non-GAAP measures are disclosed widely, and relied upon by financial statement users.

## Appendix

### Summary of U.S. regulations for non-GAAP measures

In the U.S., two Securities and Exchange Commission (SEC) regulations govern the use of non-GAAP measures. One includes general rules regarding disclosures of non-GAAP financial measures; the other governs the use of non-GAAP financial measures in SEC filings. The general rules, referred to as Regulation G, apply whenever a registrant discloses non-GAAP measures (e.g., in press releases, investor decks, earnings calls). Regulation G requires a presentation of, and reconciliation to, the most directly comparable non-GAAP measure. For non-GAAP measures included in SEC filings, the regulation (included in Regulation S-K) has four requirements and several prohibitions. It requires a presentation of:

- The most comparable GAAP measure with equal or greater prominence;
- A reconciliation between the non-GAAP measure and the GAAP measure;
- A statement disclosing why the measure is useful; and
- If material, any other purposes for which management uses the non-GAAP measure.

### Summary of international and Canadian regulations for non-GAAP measures

International Financial Reporting Standards (IFRS) do not prohibit the use of non-GAAP measures; however, we believe companies should consider local regulatory and listing requirements. Some countries entirely prohibit the use of such measures; others have restrictions on how non-GAAP measures are presented. We believe deviations from IFRS that limit information availability and transparency should be avoided entirely, and non-GAAP measures permitted by local regulatory requirements should be:

- Carefully defined, so that users of financial statements can make an assessment of comparability between companies; and
- Presented consistently from one year to the next.

In Canada, the Canadian Securities Administrators (CSA) provide guidance in CSA Staff Notice 52-306 (Revised)—Non-GAAP Financial Measures and Additional GAAP Measures. The CSA Staff Notice recognizes the International Accounting Standard (IAS) 1 requirements, and sets out practices when presenting additional GAAP measures in IFRS financial statements and disclosures that should accompany non-GAAP financial measures. The Notice also specifically discusses the use of EBIT and EBITDA, "Results from Operating Activities," "Adjusted Statement of Comprehensive Income," and additional columns in presentation of the results of operations. **CW**

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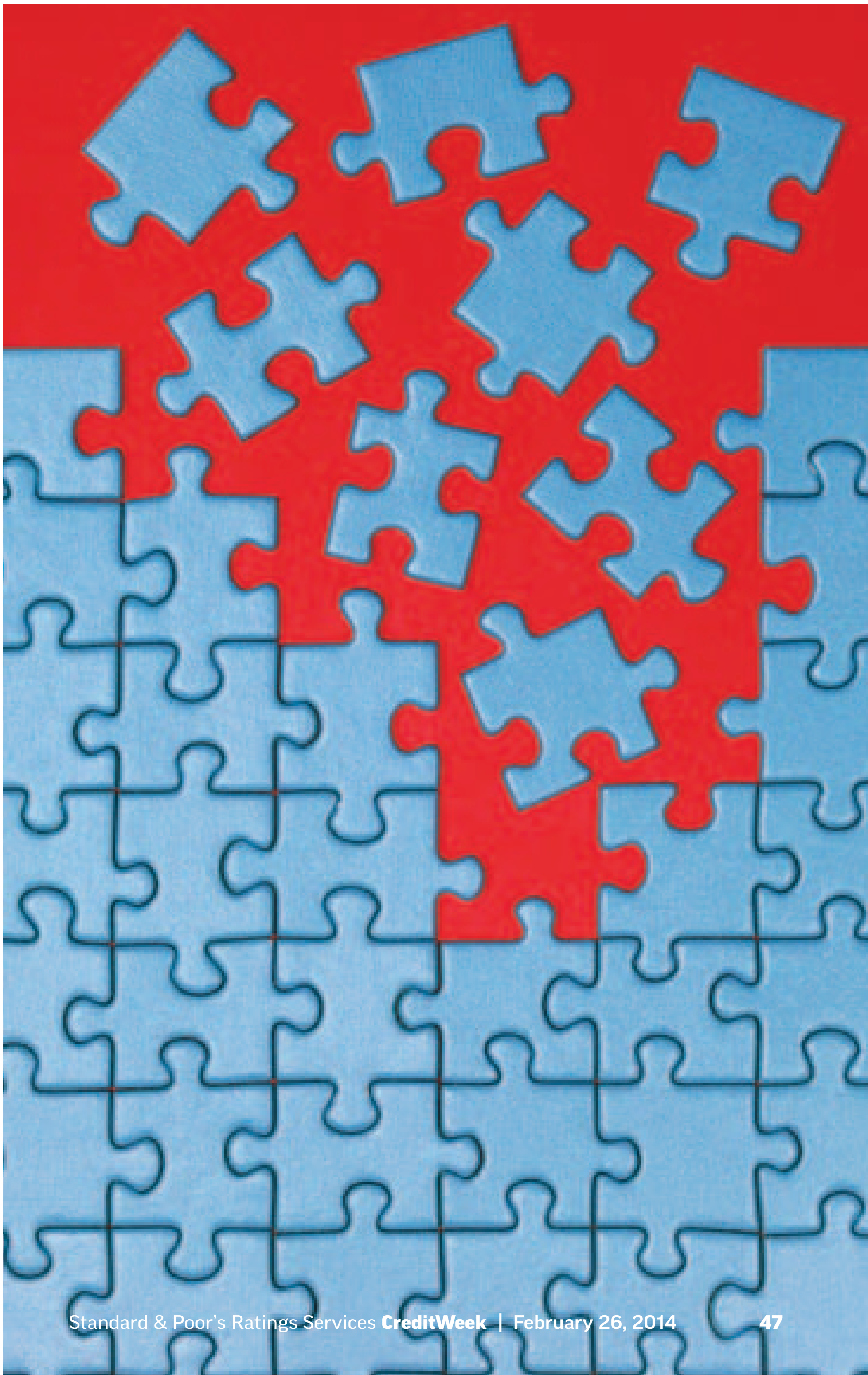
# Analytical Dilemmas When Using Non-GAAP Measures In The U.S. Insurance Sector

U.S. generally accepted accounting principles (GAAP) provide a common accounting framework for companies to disclose financial results and measures. However, a company may adjust its GAAP measures to better capture and communicate certain elements of its financial performance to investors and other financial statement users. The SEC permits the use of such "non-GAAP" measures if they comply with Regulation G and Item 10(e) of Regulation S-K (which we discuss in further detail). And while we believe non-GAAP measures can offer insight into an individual company's results, they often aren't easily comparable across peers—a big drawback for investors or other parties when trying to gauge different companies' relative performance.

Standard & Poor's Ratings Services does not routinely use a company's non-GAAP measures in our ratings analysis. Rather, we make analytical adjustments to GAAP or statutory information in the insurance industry to derive what we believe are analytically relevant financial measures. However, we believe non-GAAP measures can indicate how management views its financial position and performance and can be useful in our overall financial and business risk profile assessments. As such, we recently reviewed non-GAAP measures among 12 U.S. insurance companies in the life and property and casualty sectors highlighted in their third-quarter 2013 financial information to gauge their comparability.

## Inconsistencies In Exclusions And Disclosure Hinder Transparency

Our review revealed certain inconsistencies and areas of incomparability among key non-GAAP financial meas-



ures some insurers reported, resulting from differences in how they derive these measures. The calculation of non-GAAP income is a case in point: While we observed some consistencies in the exclusions companies made from GAAP-reported information to arrive at this measure (e.g., all excluded realized gains and losses), there were many significant inclusions and exclusions that were specific to only one or a few companies *(see table 1)*. While the insights provided under non-GAAP measures offer an additional view into a company's results, they are not easily comparable across peers. For example, in its third-quarter 2013 earnings release, The Allstate Corp. reported eight reconciling items between net income (a GAAP measure) and operating income (a non-GAAP measure), while The Travelers Cos. Inc. reported only one reconciling item (realized gains and losses).

The combined ratio (the sum of the loss ratio and expense ratio) is a common measure of a property and casualty insurance company's underwriting performance for a certain period. The loss ratio and expense ratio generally have the same denominator, net earned premium, but the numerator for the loss ratio is incurred losses and for the expense ratio is expenses. Because it is a common ratio, it can also be used to compare companies against each other to assess underwriting performance overall, or by line of business; however, this is only possible if the ratios are calculated consistently. Many insurers provide a pure combined ratio consistent with the calculation above, but certain insurers make adjustments to it, resulting in a non-GAAP adjusted combined ratio. For example, we noted that while certain exclusions are consistent across all companies (e.g., catastrophe losses), some companies make other unique adjustments. As such, financial statement users will need to be cognizant of how a company defines its ratio to ensure that they can make valid comparisons *(see table 2)*.

Variations in how companies define certain exclusions can also introduce inconsistencies. For instance, while catastrophe losses are a common exclusion in non-GAAP adjusted combined ratios, companies have the discretion to define what losses they consider catastrophic. For example, from a quantitative threshold perspective, Allstate considers an event a catastrophe if it generates pretax losses before reinsurance in excess of $1 million; for Hartford, a catastrophe is an event that causes $25 million or more in industry-insured property losses. Therefore, although catastrophe losses may be a common exclusion, the wide variations in how insurers define the term may render the resulting ratios incomparable.

**Table 1 | Items Companies Exclude To Derive Non-GAAP Income Statement Measures**

| |
|---|
| Realized gains and losses (including derivatives) |
| Specific revenue stream (e.g., run-off, closed-block of business, discontinued operations) |
| Goodwill and intangible impairment and amortization |
| Investment income |
| Other-than-temporary impairments |
| Changes to accounting guidance |
| Interest expense, including debt |
| Joint ventures and non-controlling interests |
| Restructuring costs |
| Extinguishment of debt |
| Business combinations |
| Extraordinary items |

**Table 2 | Combined Ratio Adjustments**

| Company | Exclude from incurred losses: catastrophe losses | Exclude from incurred losses: prior period reserve development | Add to incurred losses: crop derivative business included in realized gains/losses | Include/exclude: policyholder dividends | Exclude from losses and expenses: allocated fee income | Exclude from expenses: business expense and amortization of purchased intangible assets | Exclude from expenses: billing and policy fees |
|---|---|---|---|---|---|---|---|
| Ace Limited | X | X | X | | | | |
| Allstate | X | X | | | | X | |
| Travelers | X | X | | Exclude | X | | X |
| CNA Financial Corp. | X | X | | Include | | | |
| Cincinnati Financial Group | X | X | | | | | |
| The Chubb Corp.* | X | | | Exclude | | | |
| The Hartford | X | X | | Include | | | |

*Chubb Corp. calculates its expense ratio (a component of the combined ratio) using net premium written, rather than the commonly used net premium earned. It does, however, use net premium earned when calculating its loss ratio: This results in a combined ratio that is the sum of two ratios with different denominators.

Companies can also vary widely in the robustness of their disclosures. Item 10(e) of Regulation S-K requires a company to disclose the reasons it believes a particular non-GAAP measure provides useful information to investors. Certain insurers provide a general statement that these measures allow for a better understanding of the company's business performance, without providing greater detail about each exclusion. The following three earnings release or financial supplement disclosures provide a good illustration of these variations: Principal Financial Inc.'s is very general, while Lincoln Financial Group offers a bit more detail, and Cincinnati Financial Corp. provides more robust disclosure, specifically related to one of its exclusions, realized gains or losses:

**Principal Financial Inc.**

"...We use a number of non-GAAP financial measures that management believes are useful to investors because they illustrate the performance of our normal, ongoing operations, which is important in understanding and evaluating our financial condition and results of operations." *(Principal Financial Inc., Sept. 30, 2013, financial supplement.)*

**Lincoln Financial Group**

"...Management believes that these performance measures explain the results of the company's ongoing businesses in a manner that allows for a better understanding of the underlying trends in the company's current business because the excluded items are unpredictable and not necessarily indicative of current operating fundamentals or future performance of the business segments, and, in most instances, decisions regarding these items do not necessarily relate to the operations of the individual segments." *(Lincoln Financial Group, Sept. 30, 2013, earnings release.)*

**Cincinnati Financial Corp.**

"...While realized investment gains (or losses) are integral to the company's insurance operations over the long term, the determination to realize investment gains or losses in any period may be subject to management's discretion and is independent of the insurance underwriting process. Also, under applicable GAAP accounting requirements, gains and losses can be recognized from certain changes in market values of securities without actual realization. Management believes that the level of realized investment gains or losses for any particular period, while it may be material, may not fully indicate the performance of ongoing underlying business operations in that period." *(Cincinnati Financial Corp., Sept. 30, 2013, earnings release.)*

In recent years, we have seen an increase in comment letters from the SEC to companies with respect to non-GAAP measures and compliance with Item 10(e). The most notable exception related to companies giving greater prominence to non-GAAP measures than GAAP measures, but also with respect to not adhering to required reconciliations to the most comparable GAAP measure and disclosure of the usefulness of the measure to investors. Notwithstanding compliance with Regulation G and Item 10(e), companies have a great deal of flexibility when selecting potential items to exclude from GAAP measures, making comparability very difficult. We believe disclosures of the nature and rationale of adjustments to the GAAP-reported amounts can be enhanced and made more consistent.

## Non-GAAP Income Calculations Diverge Widely Between Sectors

We noted a distinct divergence between life insurers and property and casualty insurers when it relates to the impact of non-GAAP measures on income: On average, non-GAAP income for life insurers exceeded its GAAP measure by 35%, whereas for property and casualty insurers, non-GAAP income was 11% below the GAAP measure *(see table 3)*. This means that if reported GAAP income were $100, then, based on our sample of third-quarter 2013 financial filings, the average non-GAAP income would be $135 for life insurers and $89 for property and casualty insurers.

The figures above indicate that life insurance companies generally make more adjustments to GAAP measures than property and casualty companies, while reflecting income that can vary significantly from the respective GAAP measure. For the life insurers in our sample, the most significant and pervasive exclusion affecting income was derivative gains or losses. While certain property and casualty insurers also adjust for this, their amounts are generally much smaller due to lower use of derivatives compared with life insurers.

One could draw different conclusions based on these results, noting that GAAP measures tend not to accurately reflect the true financial performance of a life insurance company. One could also conclude that life insurers take advantage of the flexible nature of non-GAAP measures to adjust their financial results; or that these companies tend to be more complex and thus require additional adjustments than their property and casualty counterparts. For property and casualty companies, we believe the trend speaks to the fact that both investors in these companies and the management teams themselves generally believe GAAP income better reflects these companies' financial performance. This is evident from the relatively few reconciling items in their non-GAAP measures compared with those for life insurance companies, which include considerably more adjustments or exclusions from GAAP.

One example of the complexity of a non-GAAP measure is MetLife Inc.'s reconciliation of operating earnings to the GAAP measure "Income/(Loss) from Continuing Operations (net of income tax)," which the company included in its Sept. 30, 2013, earnings release *(see table 4)*.

Highlighting the significance of certain reconciling items, the adjustment related to derivative gains or losses is 56% of reported GAAP net income from continuing operations. In addition, certain of the adjustments include several components, making it difficult to fully comprehend the adjustment. See the description of the adjustment related to "Net investment income" in MetLife's Sept. 30, 2013, earnings release:

"Net investment income: (i) includes amounts for scheduled periodic settlement payments and amortization of premium on derivatives that are hedges of investments or that are used to replicate certain investments but do not qualify for hedge accounting treatment, (ii) includes income from discontinued real estate operations, (iii) excludes post-tax operating earnings adjustments relating to insurance joint ventures accounted for under the equity method, (iv) excludes certain amounts related to contract holder-directed unit-linked investments, and (v) excludes certain amounts related to securitization entities that are variable interest entities consolidated under GAAP."

## Broad Definitions Leave Room For Variation

Non-GAAP measures are generally broadly defined by companies, giving them considerable flexibility in managing their financial metrics each reporting period. Many of the companies in the sample used the terms "certain" and "as applicable" when referring to what exclusions or inclusions they might use, giving them broad discretion. For example, companies may exclude "certain realized gains or losses" or "certain restructuring costs," creating challenges when analyzing non-GAAP measures year over year or company to company. Furthermore, although not very common, companies can revise how they define or calculate non-GAAP measures at their discretion. Prudential Financial Group Inc. revised its definition of "Adjusted Operating Income" in 2010 to reflect an adjustment in how it calculates hedging results on its annuity business, and Protective Life Corp. updated its definition of "Operating Income (loss)" in 2012. Investors and other financial statement users need to be mindful of such changes and compare non-GAAP measures and definitions period-over-period to ensure consistency.

**Table 3 | Variation By Sector**

| | Non-GAAP income to GAAP income (%) | Average number of reconciling items* |
|---|---|---|
| Life insurance sector | 135 | 8 |
| Property and casualty insurance sector | 89 | 3 |

*Because non-GAAP measures and reconciliations do not have a required format, reconciling items were assessed using reconciliation tables or descriptions provided by the respective companies. In the event companies aggregated adjustments, we attempted to disaggregate adjustments to the extent information was available.

**Table 4 | The Complexity Of Non-GAAP Measures—MetLife Inc.**

(For the three months ended Sept. 30, 2013)

| Line item | Adjustment made (mil. $) | Adjustment as a percentage of GAAP income* |
|---|---|---|
| Operating earnings – non-GAAP measure | 1,530 | 157 |
| Universal life and investment type product policy fees | 96 | 10 |
| Net investment income | (17) | (2) |
| Other revenues | (10) | (1) |
| Net investment gains (losses) | (85) | (9) |
| Net derivative gains (losses) | (546) | (56) |
| Total adjustments to revenue | (562) | (58) |
| Policyholder benefits and claims and policyholder dividends | (468) | 48 |
| Interest credited to policyholder account balances | (128) | 13 |
| Amortization of DAC and VOBA | 138 | (14) |
| Amortization of negative VOBA | 13 | (1) |
| Interest expense on debt | (29) | 3 |
| Other expenses | (67) | 7 |
| Total adjustments to expenses | (541) | 56 |
| Provision for income tax (expense) benefit | 546 | 56 |
| *Income/(Loss) from continuing operations (net of income tax) – GAAP measure | 973 | 100 |

## The SEC Provides Management Guidance For Reporting Non-GAAP Measures

The SEC disclosure regulation, Regulation G, defines a non-GAAP financial measure as a numerical measure of an issuer's historical or future financial performance, financial position, or cash flow that:

- "…excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure calculated and presented in accordance with GAAP."

Regulation G addresses non-GAAP measures included in any public disclosures by any registrant that has a class of securities registered under the Securities Exchange Act of 1934 (Exchange Act) or is required to file reports pursuant to the Exchange Act (e.g., press releases, investor conference calls and presentations), whereas Item 10(e) addresses non-GAAP measures included in all filings with the SEC under the Securities Act of 1933 (Securities Act) and the Exchange Act (e.g., Form 10-K, Form 10-Q, and proxy statements).

In 2010, the SEC issued new guidance in the form of "Compliance and Disclosure Interpretations" permitting non-GAAP measures to adjust for items that are not required to meet the SEC definition of "nonrecurring." This change, coupled with the restrictive nature of classifying items as "extraordinary" on the face of the income statement, contributed to companies' pervasive and widespread use of non-GAAP measures to provide investors and other financial statement users further insight into their performance.

## Proposed Accounting Changes For Insurance Contracts May Increase The Use Of Non-GAAP Measures

In June 2013, the Financial Accounting Standards Board (FASB) put forth a proposal, Insurance Contracts (Topic 834), that includes significant changes to GAAP reporting, and it may also affect the reporting and general use of non-GAAP measures. Several companies, including Genworth Financial Inc., CNA Financial Corp., Nationwide, Lincoln Financial Group, and Travelers, noted in their respective comment letters to the FASB that the number and use of non-GAAP measures and other key performance indicators will likely increase under the proposal. In addition, reconciliations to U.S. GAAP metrics may become more complex and convoluted for financial statement users, considering how much non-GAAP measures may deviate from their respective GAAP measures. It may also become more difficult for companies to report these non-GAAP measures "with equal or less prominence" than the comparable GAAP measure, which is a requirement of Item 10(e). For example, if a company highlights a non-GAAP measure in a headline at the beginning of an earnings release without the related GAAP measure, it will be difficult for the company to match its prominence elsewhere in the document, and it may potentially receive a comment letter from the SEC for noncompliance with respect to Item 10(e). The FASB is currently re-deliberating the insurance contracts proposal following the comment period. If the final standard is consistent with the exposure draft issued in 2013, investors and other financial statement users—and more importantly, the companies themselves—will likely need to reassess key performance indicators and non-GAAP measures.

## Our Approach To Adjusting Financial Information

Although we do not routinely use a company's non-GAAP measures in our ratings analysis, they can provide insight into how management views its financial position and performance and can be useful in our overall financial and business risk profile assessments. We make use of our own metrics (as defined in our insurance industry criteria), which we derive by adjusting GAAP or statutory measures. These include our calculation of economic capital available and total adjusted capital, as detailed in our ratings methodology.

Companies generally adjust GAAP information to produce a measure that reflects the performance of their core business, whereas our adjustments support our assessment of an insurer's overall credit quality. To illustrate this point, a common exclusion by management would be to remove the income-statement impact of a run-off or non-core book of business. However, the revenue or losses relating to these businesses may have, in our opinion, a true economic impact on capital, liquidity, or other factors that ultimately influence the company's creditworthiness, and we may consider them in our analysis, as we deem appropriate. For more information on our methodology for analyzing insurers' capital adequacy, see *"Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model,"* published June 7, 2010, on RatingsDirect.

## Including Non-GAAP Measures In The Audit May Increase Consistency And Reliability

Although certain components companies use to produce non-GAAP measures can be traced to the audited financial statements, the measures themselves are not audited. In addition, they are not routinely subject to formally tested controls (as are amounts included in the company's Form-10k), because the audit report does not opine on them. As such, there is a lower level of independent assurance, and therefore an increased potential for errors or inconsistencies in comparison with audited metrics. An April 2013 article by public accounting firm PwC, "Insights from the Investment Community—Non-GAAP measures," said, "Some investors desire assurance on non-GAAP information that is used for building economic models. Those investors indicated that the reliability and consistency of this data are important to them when analyzing company performance. We support exploring the idea of auditors providing assurance on such metrics, including whether there is sufficient market demand for such assurance, an appropriate reporting framework, and a conclusion that, overall, the benefits justify the additional costs."

Subjecting non-GAAP measures to audit procedures could provide additional comfort to financial statement users and reduce certain concerns that may exist today surrounding data reliability. However, it would not fundamentally change our credit ratings methodology and approach. **CW**

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**GAAP**

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# U.S. Banks' Disclosures Have Grown, But Many Financial Risks Remain Opaque

## Overview

- With U.S. regulators and accounting standard setters targeting disclosure reform and questioning disclosures' effectiveness, we find U.S. bank disclosures have grown, but still lack completeness, transparency, and consistency, making it difficult to compare U.S. banks' financial risks.
- Many parts of a bank's financial statements, particularly in the areas of litigation risk, equity components, interest rate sensitivities, liquidity and collateral management, repurchase agreements (repos), hedging activities, and fair value measurements remain opaque, making increased transparency for investors and other users all the more vital.
- From our recent review of financial filings, we offer suggestions that could improve the opacity of U.S. financial institutions' public disclosures in these areas almost immediately.
- Bank disclosures require particular attention because of the inherent complexities of an industry subject to continuous reform and valuation uncertainties related to their on- and off-balance-sheet assets and liabilities.
- Disclosure weaknesses ultimately weigh on the market sentiment of banks' financial strength and hinder greater confidence and stability of the industry. Without investor trust, the likelihood of another financial crisis based on transparency flaws could grow, particularly if market volatility accelerates.

With the annual financial reporting season in full swing, financial institution investors' attention likely will turn to the reams of disclosures banks provide to help inform them of the risks involved with an existing or potential new investment. To increase credibility after the financial crisis, many banks have gone to considerable lengths to disclose more information about their myriad financial risks, especially because so many market constituents believe a lack of transparency exacerbated the financial crisis.

Still, despite the sheer increase in the volume of information reported—both in SEC filings based on U.S. Generally Accepted Accounting Principles (U.S. GAAP) and reports filed with regulatory authorities (e.g., Federal Reserve Y-9C filings)—Standard & Poor's Ratings Services believes current disclosures still lack completeness, transparency, and consistency, which impedes a greater understanding of financial risks and a deeper level of financial analysis. Many parts of a bank's financial statements, particularly in the areas of litigation risk, equity components, interest rate sensitivities, liquidity and collateral management, repurchase agreements (repos), hedging activities, and fair value measurements remain opaque, making increased transparency for investors and other users all the more vital. We believe this ultimately weighs on the market sentiment of banks' financial strength and hinders greater confidence and stability of the industry. Without investor trust, the likelihood of another financial crisis based on transparency flaws could grow, particularly if market volatility accelerates.

In our recent review of financial filings, we found areas where U.S financial institutions can enhance their public disclosures almost immediately (these are in addition to those we highlighted in *"A Case For Greater Disclosure, Transparency, And Uniformity In U.S. Banks' Financial Reporting,"* published Dec. 10, 2012, on RatingsDirect, which remains relevant). We believe filling these disclosure gaps could allow greater transparency of financial risks and more incisive comparisons across U.S. banks. This, in turn, could strengthen market discipline.

## U.S. Regulators And Accounting Standard Setters Target Disclosure Weaknesses

The SEC recently questioned whether the U.S. public disclosure regime as a whole is generating the information that a reasonable investor would need to make decisions. Great effort is underway to consider the most effective way to reform and modernize existing disclosure requirements to ensure they are meaningful and effective, and to address some preparers' concerns about 'disclosure overload'. In reviewing the current disclosure regime, the SEC is examining not just the type of information presented but also the manner in which it could best be presented. Similarly, the Financial Accounting Standards Board (FASB) is targeting more improved disclosures for all users of financial statements by adding a disclosure framework project to its agenda, which we have long supported *(see "The FASB's Disclosure Framework Will Change The Financial Reporting Landscape," published Dec. 7, 2012)*.

*Legal expenses for the largest U.S. banks have been significant in the aftermath of the financial crisis and rose for the group in 2013.*

In our view, bank disclosures require particular attention: The inherent complexities of an industry subject to continuous reform and valuation uncertainties related to their on- and off-balance-sheet assets and liabilities make bank financial statements particularly difficult to decipher.

## Disclosures Allow For More Meaningful Peer Comparisons

Robust disclosures serve multiple purposes, including more meaningful peer comparisons, because accounting measures presented in the basic financial statements alone are not sufficient to meet the needs of analysts. When calculating ratios we use in our credit analysis, we employ a long-standing practice of making analytical adjustments to a bank's reported results—whether they are reported in SEC filings or banks' regulatory filings, both of which we use. These adjustments produce measures that meaningfully reflect our view of underlying economic realities and improve comparability among banks. This enhances the analytical relevance and consistency of the key performance metrics we use in our credit analysis. We generally make our analytical adjustments based on financial statement disclosures, and so, attention to the information provided in the footnotes is all the more necessary.

Similar to our wish list published in December 2012, for the purpose of our ratings analysis banks may share some of this information with us on a bilateral and confidential basis, if it is relevant to our analysis. However, because we do not share confidential data, we cannot disclose it in our public reports, limiting our ability to provide sufficient awareness to investors. We believe enhanced disclosures in the areas discussed here would help investors better assess the relative risks of global banks.

## More Transparency And Consistency In Legal Risk Disclosures

Legal expenses for the largest U.S. banks have been significant in the aftermath of the financial crisis and rose for the group in 2013. Banks typically do not disclose their legal reserves, although we would find that information valuable. Bank managements, though, do publicly disclose every quarter their maximum possible losses in excess of reserves. We are somewhat skeptical, however, about how meaningful an estimate of possible losses in excess of reserves really is. For example, JPMorgan Chase (JPM) posted a $9.2 billion addition to legal reserves in the third quarter of 2013. Its range of reasonable possible losses above its legal reserve was up to $5.7 billion. But in the previous quarter, this figure was $6.8 billion. So, in essence, JPM took an additional $9.2 billion in legal expenses in the third quarter of 2013—well above its previous reasonable possible loss estimate. And still, its reasonable possible losses in excess of reserves declined by only $1.1 billion *(see "The Largest U.S. Banks Should Be Able To Withstand The Ramifications Of Legal Issues," published Nov. 25, 2013)*.

Bank managements can add to their legal reserves only if a legal loss is both estimable and probable. Despite the high amount of quarterly legal expenses that banks have already incurred, we believe that some banks' legal reserves, which we estimated as of the third quarter based on JPM's actual legal reserve disclosure in that period, may not be sufficient to cover the full amount of additional legal settlements that may arise. To arrive at our analytical conclusion, we needed to cull through a bevy of public documents to understand the potential legal exposure. For example, to estimate the bank's exposure to mortgage-related Federal Housing Finance Agency (FHFA) lawsuits, we reviewed documents FHFA publicly provided, which detailed the merits of its suit and provided original unpaid balances. We acknowledge that our conclusion was based on a significant number of assumptions, and ultimate legal obligations could vary. However, we conducted this exercise because this information was not available in most bank-specific public disclosures.

In terms of legal risk disclosure, we believe a summary of all legal exposure in table form would be useful for investors. Currently, some of this information is available as a verbal summary in the financial statements, making it difficult to track. We suggest such a table should be broken down as follows:

- By type of legal exposure (e.g., mortgage, foreign exchange, LIBOR, etc.);
- By the various litigants that have filed a lawsuit (e.g., investors, Department of Justice, Attorney General, etc.);
- By the various legal avenues the bank is exposed to for each category detailed above (e.g., civil, fraud, fines, etc.); and
- By the original unpaid balances connected to each potential lawsuit. This is a key point, because we believe investors need comparable information from which they could then make their own assumption to determine possible losses.

This sort of table would be a vast improvement over the current form of disclosing legal issues, which largely confuses readers in terms of providing information about overlapping lawsuits. We have long supported improved and expanded disclosures into all loss contingencies, including litigation matters *(see "Standard & Poor's Ratings Services Comments On Proposed Amendment To FASB Statements No. 5 And 141(R)," published Aug. 12, 2008).*

## Greater Regulatory Focus On Banks' Accumulated Other Comprehensive Income Components Requires More Granular Disclosure

The newly finalized Basel III regulatory capital rules for U.S. banks place greater attention on accumulated other comprehensive income (AOCI) balances, a significant component of equity (capital) for U.S. banks. These new regulatory capital rules eliminate many of the prudential filters that had removed the effects of unrealized gains and losses on capital ratios. As a result, we believe bank AOCI balances require more granular disclosure in the financial statements to facilitate more refined analysis. For instance, under the current risk-based capital rules, unrealized gains and losses that exist in AOCI on available-for-sale (AFS) debt securities are not included in regulatory capital. However, under Basel III, U.S. banks that follow the "advanced approach" will include all unrealized gains and losses on banks' AFS securities in calculating their common equity Tier 1 ratios. Banks on the "nonadvanced approach" have a one-time opportunity to opt out.

The consideration of other unrealized gain and loss components of AOCI, such as cash flow hedges, is more challenging. In particular, changes in the fair value of cash flow hedges may or may not be filtered out of capital ratios, depending on the nature of the hedged item's accounting. That is, if the cash flow hedge is hedging an item that is recognized on a bank's balance sheet at fair value (e.g., an investment security) then the value of the cash flow hedge derivative is included in the Basel III ratio. However, if the cash flow hedge is hedging an item that is not at fair value (e.g., a loan, which is recorded at amortized cost), then it will be excluded from Basel III ratios.

Financial reporting disclosures currently do not separate the types of items that cash flow hedges are used for with sufficient granularity. We believe this will become more relevant as U.S. banks move closer to the effective date of Basel III compliance, as early as 2015 for many *(see "Large U.S. Banks' Basel III Capital Management Grows More Complex As Interest Rates Rise," published Oct. 1, 2013).*

## More Consistent Disclosure Regarding Interest Rate Sensitivity

With interest rates creeping higher and likely to further rise in the future, the issue of interest rate sensitivity is gaining renewed focus. Investors need to understand the impact of a rise in interest rates (and a fall, if applicable) on banks' profitability and capital. Banks provide this information in various forms, but consistency falls short, in our opinion. For example, regarding net interest income, bank managements typically provide the sensitivity to a 100-basis points (bps) rise in interest rates. However, that increase could come in several forms: a rise in short-term rates only, a parallel shift in the yield curve (both short-term rates and long-term rates rising simultaneously), or a rise in long-term rates only. The latter scenario is most plausible in the current rate environment, in our view. However, not all banks provide the impact of such a scenario. Bank managements most typically provide only the effect of a parallel shift, which would have much more positive impact on net interest income than just a rise in long-term rates.

The other key focus, given the rules under Basel III, relates to the effect of rising interest rates on banks' investment portfolios, which have grown in size over the past few years. Banks typically disclose a breakdown in maturity of their securities portfolio by year (e.g., less than one year, one to three years, three to five years, greater than five years, greater than 10 years), which is helpful. However, when it comes to residential mortgage securities, some banks estimate the prepayment speed of these securities, while others don't and provide only their contractual maturity. This lack of consistency limits the financial statement user's ability to conduct more refined analysis.

For example, on a contractual basis, most residential mortgage-backed securities (RMBS) mature in greater than 10 years, but, because of a mortgage owner's ability to prepay, the maturity dates in actuality are less than 10 years. As interest rates rise, RMBS are likely to stay on a bank's balance sheet longer. And so, if a bank was aggressive in its prepayment estimates, it may show an investment portfolio maturing much quicker than actuality. We believe it would be more helpful for banks to bucket their maturities without estimating prepayment speed but rather using actual maturity, and separately disclose the effect on contractual maturities because of management's assumed prepayment speeds. That would allow investors to make their own adjustments to the speed of prepayments.

*The accounting for repos has gained particular attention and notoriety in recent years.*

To get a more accurate understanding of a bank's sensitivity to rising interest rates within its securities portfolio, in our analysis, we tend to analyze actual loss performance of portfolios during a period of rising interest rates. For example, we conducted this exercise in the second quarter of 2013 when long-term interest rates rose 66 basis points (bps; *see "Large U.S. Banks' Basel III Capital Management Grows More Complex As Interest Rates Rise," published Oct. 1, 2013).* We were able to calculate the losses of banks' securities portfolios, with the assumption that a lower loss rate translates into shorter-dated securities within the investment portfolio. Notably, we found differences in the ranking order of a bank's actual performance regarding loss rates in comparison to their disclosure regarding the maturity of their securities portfolio. That means in some cases, banks had higher actual loss rates than what could be inferred from the disclosed maturity of their securities portfolio.

Another useful disclosure banks supply relating to securities portfolios are the interest rate the portfolios return—the notion being that a higher interest rate should indicate higher risk in the portfolio (excluding timing-of-purchase considerations). However, some banks disclose this figure after netting the hedge for these instruments, while others disclose it on an absolute basis. For investors and financial statement users, it would be helpful if banks disclose the interest rate of the securities portfolio unblemished and then separately disclose the effect on yield from any accounting or economic hedges. In this way, investors can more easily compare banks and understand whether the hedges in place are actually effective.

## Repo Arrangements Can Mask Significant Risk, But Greater Transparency Is Coming

The repo market is a large and important short-term financing channel for most financial intermediaries. Its functioning and transparency is an important element to the stability of our financial system. Yet the disclosures of repos and similar arrangements remain inadequate, in our view. The accounting for repos has gained particular attention and notoriety in recent years. The financial crisis exposed efforts by some high-profile financial institutions (like Lehman Brothers) to change certain elements of these arrangements to achieve sale accounting treatment—and keep repo arrangements off-balance-sheet. In 2012, the FASB made effective new rules that tightened the qualifying criteria for accounting for repos as a sale. The rules intend to prevent similar transactions such as those Lehman conducted from occurring again. Still, some common repo arrangements—such as repo-to-maturities—continue to get off-balance-sheet treatment, with limited information provided about them.

Repo-to-maturities (a type of arrangement now-bankrupt MF Global Holdings used) have traditionally been accounted for off-balance-sheet, even though these arrangements are similar to secured financings, in our view, which generally maintain on-balance-sheet treatment. We believe banks that account for repos off-balance-sheet should provide additional disclosure, such as the carrying amounts of assets removed from the balance sheet and any new amounts recognized (such as derivative assets).

Moreover, for all repos (and similar arrangements, such as securities lending) that are accounted for on-balance-sheet, we believe the disclosure regarding the asset quality of the transferred assets underlying those transactions should be improved. This is important for the purposes of assessing liquidity and a bank's financial flexibility during times of need. We are pleased that in December 2013, the FASB tentatively agreed to finalize a proposal that would offer this information. We expect final rules to be released by the end of first-quarter 2014.

We welcome greater transparency of repos and similar arrangements. We believe such improved disclosures are a positive step toward instilling greater confidence in the repo market *(see "Lifting The Veil: Increasing Transparency And Resilience For Banks, Nonbanks, And Investors In The Triparty Repurchase Agreement Market," published March 21, 2013)*.

## Transparent And Consistent Liquidity Disclosures Are Sorely Lacking

U.S. banks' disclosures around liquidity risk have been particularly deficient and inconsistent, in our view. Understanding the risks banks may encounter in meeting their financial obligations—and the ways those risks are managed—is crucial. Since the financial crisis, we find that some bank disclosures about liquidity risk have expanded somewhat. However, most of the information provided relates to generic descriptions of banks' risk management processes and lacks the detail of tangible evidence that would substantiate managements' conclusions about how they manage such risks. Where there is disclosure on sources of liquidity or stress-testing results, it is not related to liquidity needs and does not allow readers to reconstruct the findings.

To provide greater clarity of potential liquidity risk, we prefer that banks show maturity profiles of their assets and liabilities, and do so in a consistent format. We believe the reporting of cash flows should be based on the expected (or at a minimum, contractual) maturities of all assets and liabilities, assuming that bank clients would exercise options granted to withdraw money at the earliest possible time. We would find it useful if the maturity profiles were broken down by several time buckets and differentiated by different types of balance-sheet items.

Furthermore, we would also like to see greater transparency related to the way collateral is managed. In our view, detailed disclosure on the collateral that banks have received or pledged, and on assets that may otherwise be restricted, would improve liquidity analysis. It would also inform market participants about the amount and nature of assets on which the banks have granted secured creditors a preferential claim.

## More Clarity And Consistency About Hedging For Mortgage Servicing Rights Is Needed

Rising interest rates in the U.S. have caused the values of mortgage servicing rights (MSRs) on the balance sheets of many banks to grow, and an improving economy could make them climb even higher. Higher MSR valuations will likely help offset weakening earnings from a slowdown in mortgage lending.

As interest rates rise, we believe some U.S. banks could seek to bolster reported earnings by decreasing their economic hedging activity. If mortgage interest rates—along with MSR valuations—continue to climb, banks could realize potentially larger net gains in earnings. If these net valuation gains become outsized, banks could take excessive interest rate risk, which we may view negatively in our ratings. Traditionally, in managing interest rate risk, some large U.S. banks have used a combination of investment securities (classified as trading or available-for-sale securities because both are recorded at fair value) and freestanding derivative contracts, such as interest rate swaps to hedge—or to offset—changes in their MSR portfolio's fair value.

Although the extent of these economic hedges directly affects recorded earnings, gauging their full effect is difficult because of limited disclosures. Banks often differ in how they disclose the effect of hedging activities related to MSR valuation changes: Some disclose gross MSR and risk-management hedging changes in earnings, which we prefer, while others simply disclose MSR earnings, net of hedging activities, which offers limited insight. This distinction is important because derivative protection, in particular, is often entered into for a shorter time period than the underlying economic exposure of the servicing cash flows (the life of MSRs). Moreover, if banks hedge with securities classified as trading or available-for-sale, it is difficult—if not impossible—from public disclosures alone to identify which instruments out of a total portfolio the bank has specifically earmarked as economic hedges to MSR valuation changes *(see "Can Rising Values For Mortgage Servicing Rights Offset A Dip In Mortgage Activity For U.S. Banks And Servicers?" published Sept. 23, 2013)*.

financial institutions report them *(see "Accounting Adjustments Helped Some Large U.S. Banks record Large Third-Quarter Gains," published Nov. 4, 2011)*. As a result, we believe the same adjustments potentially could be double-counted. We also have seen inconsistencies or lack of transparency in the segments of a bank's business where some of these adjustments are recorded. We recognize that measuring and reporting FVA is an emerging area. Still, we would

*We believe financial statement users want timely and relevant information about troubled banks earlier…*

## Emerging Trends In Fair Value Adjustments Require Better And More Consistent Disclosure

Beyond the fair value adjustments U.S. banks make to their balance sheets regarding changes in their own-credit (debt valuation adjustments, or DVA) and counterparty credit risk (credit valuation adjustments, or CVA), some U.S. banks have also begun to report funding valuation adjustments (FVA) related to their over-the-counter derivatives and structured notes. FVA represents an adjustment made to reflect market funding costs on uncollateralized derivatives. The cost of funding is generally built into derivative pricing. However, questions remain as to whether and how it relates to fair-value measurement principles that are defined by accounting rules. As funding costs have risen and regulation has shifted more derivatives trades to centralized exchanges, making the costs simpler to calculate, we believe we may see more U.S. banks separately recognize—and disclose—FVA.

However, we believe there could be significant overlap between FVA and DVA or CVA because of the complexities in calculating the various adjustments on a portfolio basis using market data. Similar to our observations about DVA and CVA, we believe calculations of FVA vary among banks (in the U.S. and globally), and we see little consistency in how welcome greater transparency and consistency in the way banks report all their fair value adjustments, FVA and DVA or CVA.

## Global Efforts To Improve Disclosures By Voluntary Means Have Fallen Short Thus Far

From a global perspective, the Financial Stability Board in May 2012 established the Enhanced Disclosure Task Force (EDTF), comprising banks, auditors, investors, and other users of banks' financial reporting—including Standard & Poor's—to enhance disclosures by banks. The EDTF published its report, *"Enhancing the Risk Disclosures of Banks,"* in October 2012. It sets out 32 disclosure recommendations aimed at improving clarity, timeliness, usefulness, and comparability of bank disclosures. The recommendations encompass a range of topics including risk management strategies, capital adequacy, risk-weighted assets, liquidity, funding, market risk, and credit risk. They are underpinned by seven fundamental disclosure principles—that disclosures should be: clear, balanced, and understandable; comprehensive; relevant; consistent over time; reflective of how banks manage risks; comparable; and timely.

We believe the EDTF's recommendations have the potential to increase confidence in banks by improving the quality and granularity of public information available to investors *(see "S&P Believes The Enhanced Disclosure Task Force's Recommendations Could Boost Confidence In Banks," published Nov. 2, 2012)*. But to reach that goal, the vast majority of large banking groups would have to report in a much more consistent form. From our review of how major banks complied with first-time implementation of the nonbinding recommendations, we believe bank disclosures still have a long way to go to fully deliver on comparability and relevance *(see "The Enhanced Disclosure Task Force: S&P Study Finds That Bank Reporting Has Improved But Still Falls Short," published June 26, 2013)*.

## Opaque Disclosures Often Serve To Benefit Poorly Managed Institutions

Weak disclosures tend to benefit mainly poorly managed institutions that can mask risks and weaknesses because they are not compelled by law, regulation, or accounting disclosure requirements to be fully transparent. Economic incentives (through lower cost of capital) can serve to foster greater transparency, but quantifying the magnitude of the benefit is difficult. In our view, investors sometimes penalize banks that are more transparent in exposing a possible risk that their peers probably have as well, but have chosen to remain silent about.

Although some individual banks may not fare well under more closely aligned, consistent, and transparent reporting regimes, the financial system as a whole would be better off. We believe financial statement users want timely and relevant information about troubled banks earlier—before they fail or cause widespread issues. That would go a long way in supporting confidence in the banking system and would ultimately reduce the risk that another crisis—based on a lack of transparency—could occur again *(see "Why U.S. Financial Services Investors Are Concerned That Proposed Accounting Rules Will Impede Decision Making," on p. 59)*. **CW**

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**Bank Disclosures**

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Credit FAQ

# Why U.S. Financial Services Investors Are Concerned That Proposed Accounting Rules Will Impede Decision Making

Financial statement users' views about the quality and relevance of accounting and financial reporting vary between investors and credit analysts and amongst each other. The spectrum of views may include some or all of the following: the belief that accounting has unnecessarily grown increasingly complex; the application of accounting standards and related disclosure requirements remains inconsistent; global convergence by accounting regimes is imperative; enhanced disclosures across important areas of financial services reporting is warranted; and emerging accounting standards could make investor analysis and decisions over the allocation of capital more difficult.

Standard & Poor's Ratings Services here shares the general observations and views of a group of U.S. investors who were surveyed on specific questions about the quality and relevance of certain proposed accounting and financial reporting rules. Specifically, the topics covered are the potential changes to the financial instrument credit impairment model, insurance contracts accounting and the auditor's report. Furthermore, with the year-end financial reporting season fast approaching, we share surveyed investor views about financial information they believe company managements could better disclose this year-end and going forward to better enable and bring greater efficiency and insight to analytical assessments. For each topic covered below, we also provide our views on those topics.

## The Proposed Credit Impairment Models

**Q.** ***The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have proposed far-reaching changes to the current incurred loss credit impairment model. Do you view removing the current incurred loss criteria and applying the expected losses model favorable to the measurement of credit impairments?***

**A.** Surveyed investors generally view a shift away from the incurred loss accounting model as an improvement to accounting and indicated it could be more decision-useful, which the IASB and FASB models propose to accomplish. Current credit impairment accounting rules are viewed as too restrictive whereby companies are not permitted to record sufficient reserves to cushion against potential future credit losses. Reflecting on past experience, investors surveyed cited that past accounting guidance aimed at reducing overstated reserve levels, and which ultimately led to some high-profile bank restatement, could have amplified the severity and pro-cyclicality of loan losses in the recent financial crisis. Investors noted the challenges of the incurred loss model during the financial crisis, where expected losses could not be recognized by management for financial reporting purposes. Some investors believe the incurred loss model is flawed, but view the extreme changes, particularly under the FASB's Current Expected Credit Loss (CECL) approach, as too subjective and far reaching.

However, some surveyed investors believe issues related to the recording of credit impairment during the financial crisis should not be fully attributed to the adequacy of reserve levels, but instead should be largely attributed as an underwriting issue; therefore, they have expressed the view that the proposed expected credit loss models may not solve the disconnect experienced between the reported credit loss allowance and underlying credit trends. Some of the surveyed investors believe that a majority of banks had sufficient reserves at the time of the financial crisis, and that poor underwriting practices drove the credit loss events (not the incurred loss model in isolation), so the IASB and FASB proposals may be attempting to solve the wrong problem.

**Q.** ***What characteristics of the FASB and IASB credit impairment models do you favor (i.e., are the most decision-useful)? Which do you oppose (as not relevant, or might hinder analysis)? What aspects of the FASB and IASB credit impairment models do you believe could depict the most relevant balance sheet and results of operations?***

**A.** Some surveyed investors believe the FASB's CECL approach would require estimating reserves too far into the future, thereby subjecting the credit loss estimates to significant levels of subjectivity particularly in the credit reserving for longer tail assets. Surveyed investors expressed particular concern over the potential for excessive speculation and subjectivity in calculating the expected credit loss of the asset on Day 1. In this regard, the FASB's proposal indicates companies should revert to a historical average loss experience for the future periods beyond which the company is able to make reasonable and supportable forecasts. However, some surveyed investors believe historic models generally are unreliable indicators when accounting for current expected credit losses in the financial statements. However, they believe the IASB's proposed 12-month period likely is too narrow a timeframe to capture adequate reserves for balance sheet credit exposures.

Other surveyed investors did not yet have a definitive opinion on either the FASB or IASB credit impairment models, and expressed the view that they want to learn more about the potential implications of each credit impairment loss model in the context of real-life examples. This could help them better understand how potential changes could affect companies' capital and overall financial profiles.

**Q.** ***What are some key suggestions for improving current accounting for credit impairment?***

**A.** Surveyed investors generally agree that most credit losses occur early in the life of a loan and so clearly expect those to be captured. Some investors believe a preferred approach is for companies to capture "reasonably estimable credit losses expected to occur in the foreseeable future." Those that support such a view believe estimation and occurrence uncertainty are lessened, and believe any potential future credit losses beyond this period could be absorbed through the company's capital. In addition, they note the terms "reasonably estimable" and "foreseeable future" should be explicitly defined in the standards to promote consistency in application and transparency for analysis. Further, surveyed investors made it clear they would like the FASB and IASB to arrive at a globally converged accounting and financial reporting solution for credit impairment.

**Q.** ***How does Standard & Poor's view the FASB's and IASB's proposed credit impairment models?***

**A.** We provided our views to the boards in our exposure draft comment letter responses:

- Global convergence on accounting for credit losses in our view is important. We rate companies globally and to the extent significant differences remain in the accounting for credit losses, key reported financial metrics will not be globally comparable—to the detriment of investors and other users of financial information.

*Surveyed investors generally view a shift away from the incurred loss accounting model as an improvement to accounting and could be more decision-useful…*

- We believe a forward-looking single measurement approach (such as FASB's expected credit loss model), coupled with comprehensive quantitative and qualitative disclosures, will better help analysts evaluate the adequacy of a company's credit loss reserves and provide greater insight into management's credit loss expectations that reside within its existing financial asset portfolios.
- We favor the FASB's proposed expected credit loss model over the IASB's proposed credit deterioration model, primarily because the latter may not fully address our concerns about the timely recognition of credit losses. We believe the IASB's proposal (which imposes a dual measurement approach) is more complicated and ambiguous, adding potentially unnecessary complexity to the accounting for credit losses. Unlike the IASB's proposed approach, the FASB's model does not contain any threshold or triggering event prior to recognizing expected credit losses (which we prefer); we also believe the 12-month threshold appears arbitrary (i.e., it is not clear why 12 months is better than any other cut-off period, such as 24 or 36 months, particularly because we understand some companies currently carry credit loss reserves longer than 12 months, potentially resulting in a reduction of credit loss reserves, if the IASB proposal is applied).
- We believe the IASB's proposal will likely result in a cliff effect similar to that which is widely criticized under current accounting rules. Consequently, we believe the IASB's model is less likely to dampen the procyclical effects of loan losses, because loan loss allowances may start to rise only after the start of an economic downturn, and spike once the economy takes its sharpest turn for the worse.
- Without prescribing a set method, the FASB has highlighted that it expects estimates of credit losses to be largely informed by historical loss information for financial assets of a similar type and credit risk. This information would then be evaluated in the context of how those historical loss patterns differ from what is currently expected (which would be based on current conditions, and reasonable and supportable forecasts). We believe this is a reasonable approach, but would also find it useful if companies disclose how they would apply various qualitative adjustments to historical loss experience in calculating an estimate of their allowance.

*(See our response letters to the standard setters: "FASB's Proposal Set To Revamp Accounting For Credit Losses, But Fails To Achieve Convergence With International Accounting," published July 11, 2013, and "IASB's Proposal Set To Revamp Accounting For Credit Losses, But Fails To Achieve Convergence With International Accounting," published July 16, 2013, on RatingsDirect.)*

We also provided highlights of the proposals in our February 2013 *AccountingWatch* newsletter, at http://www.standardandpoors.com/spf/upload/Ratings_US/AccountingWatch_February2013.pdf

## The Proposed Insurance Contracts Accounting Model

**Q.** ***What characteristics of the FASB's proposed insurance contracts model do you favor (i.e., the most decision-useful)? Which do you oppose (as irrelevant, or might hinder analysis)?***

**A.** Surveyed investors noted that the IASB/FASB attempt to move closer to global accounting convergence is positive for investor analysis. Separately, some applaud efforts to have standards apply to contracts and not just the entity (i.e., standards will apply to noninsurance companies), representing a step towards assessing economic substance and reflecting improved accounting.

## Surveyed Investors' Main Disclosure Requests, By Topic

| Disclosure topic | Why is this important? | Investor-suggested disclosure improvements |
|---|---|---|
| Definition of capital | Information comparability is hindered when companies apply different definitions of capital across regimes and within the same country. | Provide definitions of capital and the components that comprise capital ratios. |
| Standardized key financial metrics | Investors want comparable, consistent financial metrics across financial institutions to bolster analytical abilities. In this regard, a pre-determined reported set of key financial metrics would aid analysis. In addition, for those metrics not defined by regulators, investors benefit from explanations of the composition of those metrics. | Some examples of those financial metrics are: Common Equity Tier 1 ratio under Basel 3; Tier 1 capital ratio; Total capital ratio; Gross loans/gross total deposits; Efficiency ratio; NIM; Allowance for loan losses/ Nonperforming loans; Allowance for loan losses/Total loans; NPLs or NPAs/Total loans; Net charge offs; Leverage ratio; and Return on total assets. |
| Detailed loan, credit reserve, and deposit information | Investors face hurdles comparing loan portfolios and credit loss reserve information across global banks and amongst those in the same country. Therefore, consistent detailed disclosures are essential to provide more clarity and consistency about the nature and extent of credit risks. Investors seek globally uniform definitions to be applied, or at a minimum, disclosed for these critical balance sheet amounts. | Define Loans. For example, do "Loans" include or exclude: Loans to Other Banks (sometimes included in the Total Loan heading, but often are a separate line item, particularly for emerging market banks). Do Loans include Accrued Interest or loan-like assets, which sometimes are within Other Receivables? Other suggestions: Identify loan geography and type of loan within the portfolio and for the related reserve. Identify policy and rationale for loan-loss reserves and releases. Define nonperforming assets and loans. Identify where noncash collateral is held, including the fair market value of the collateral and the company policy and practices regarding holding noncash collateral. Provide granular loan-to-value information and discounts. Provide comparable details about impaired loans. Define Deposits. How are core deposits defined? For example, do deposits include or exclude deposits from other banks (in some cases, it includes deposits from the central bank); money market, and other deposit-like liabilities (which some banks include)? |
| Insurance industry items | Existing insurance accounting rules are globally inconsistent. The nature and extent of US GAAP are far more expansive than IFRS, but still not ideal. Surveyed investors believe certain information and measures, if disclosed today, could potentially help in the analysis of insurers. | Key information and metrics desired: Detailed information on the probable maximum loss for property and casualty companies as a basis to gauge risk tolerance; Granularity on insurers' risk and assumptions. For long-term care, provide sensitivities around morbidity, lapse, and interest rate assumptions by policy year (information should be standard, by type and presentation of information); Details on reserving for variable and fixed annuity life products (e.g., interest rate sensitivity analysis, underlying assumptions applied); Disclose more granular investment portfolio information (e.g., details on sub-prime loans). |
| Establish a disclosure framework | Some surveyed investors view company financial reports as too voluminous. Although comparable information is important, some U.S. investors are looking for differentiation, that is, they want management in its own discretion, to provide information that is relevant to its business. Standardized disclosures are important but information that distinguishes management is also viewed as relevant in analysis. | Companies should provide rational disclosures that clearly represent what is relevant and material to understanding its business operations and financial results and position. |
| Other comprehensive income | The recognition and measurement of OCI is affected by many transaction types including pensions, cash flow hedging, fair value changes in available-for-sale financial assets, and cumulative translation adjustments. As a result, interest rate risks are commingled with other movements. | Provide separate details of the nature of interest rate volatility that is embedded in the recognition of OCI. This should include factors that could cause OCI to fluctuate and the likelihood of change. |
| Hedging | Hedging relationships on balance sheet are oftentimes difficult to discern particularly when they are not designated as hedge relationships in accordance with accounting rules that require greater disclosure. | Identify the duration of securities portfolio, with and without hedging. Provide clear explanations of the correlation and the type of hedging applied including the products used to create the hedge. |
| Cash and statement of cash flows | Cash balances are essential to assessing funding and liquidity. Some surveyed investors believe the indirect cash flow statement presentation is not helpful to analysis and would prefer to see the "direct" method used more widely. | Provide information on whether cash is restricted or unrestricted. Overall, the statement of cash flows should provide clear, consistent presentation and classification of business transactions supplemented by disclosures, where the statement falls short. |

However, surveyed investors expressed concerns that they believe may outweigh the perceived benefits of the proposed insurance contracts proposal. They question whether the insurance contracts proposal in its entirety would better reflect the substance of business transactions and the manner in which insurers manage their business. Notable was the view expressed by survey participants that applying market assumptions does not create a better reporting standard when it involves long-term liabilities (i.e., life insurance reserves). There is no active market for these liabilities to derive a reasonably accurate discount rate. Hence, their view that the discount rate will likely be too speculative, and despite standard setter's attempt to conform companies to one standard in their models, surveyed investors are concerned that diversity in practice may still remain an issue. Further, with respect to the use of "unbiased and probability-weighted estimates" of future cash flows, most surveyed investors agree that further clarification from the FASB on how to apply this concept is necessary. Some investors believe single point "best" estimates have worked in their analysis for years and there is no need for change.

Some surveyed investors believe the FASB's proposal has gone beyond targeted improvements that may be necessary to enhance current U.S. reporting. They further view that in the event the board's exposure draft remains as proposed the proposal would likely make it more difficult to adjust reported financial information to arrive at a better understanding of the underlying economics and to compare historical and peer company financial metrics. For example, a potential outcome could be a global reporting insurer having multiple sets of books: U.S. GAAP, U.S. Statutory Reporting, International Financial Reporting Standards (IFRS), and non-GAAP/IFRS metrics provided to market participants which would not align in significant recognition and measurement areas.

In summary, opposing views commented that the insurance contracts proposal: will increase insurance accounting complexity; is too theoretical and impose real-life consequences that are difficult to quantify; would not enable a better understanding of insurance contracts; and will require significant time and resources to implement and analyze in order to value insurers. Some surveyed investors believe their existing earnings models would likely need to be revamped.

**Q.** ***What key suggestions do you have for improving the development of the FASB's insurance contracts standard?***

**A.** Some of the surveyed investors expressed the view that U.S. insurance contracts accounting rules are somewhat fragmented. These investors view there is an opportunity to make targeted improvements to insurance accounting standards without revamping them which in their view may be unnecessary and also potentially render current investor models obsolete.

Surveyed investors view the potential impact of the proposed standard to the financial statements of insurers as obscure and, therefore, more clarification about the manner in which financial statements would be affected is desired. Survey participants want to see real-life examples illustrating the before and after effect on all three primary financial statements which includes the statement of cash flows. In their view, the insurance contracts proposals should be fully tested and implemented at select companies prior to becoming final and the FASB should afford investors an opportunity to evaluate those outcomes to help ensure the proposal is well understood, can be implemented and analyzed properly in a timely manner.

In addition, surveyed investors believe that in the event the FASB finalizes the insurance exposure draft as proposed, extensive disclosure is necessary. See the list of some investor suggested disclosure improvements in the section below. They believe that greater transparency will assist investors in making analytical adjustments to arrive at their economically desired financial metrics.

**Q.** ***What are Standard & Poor's views on the FASB's and IASB's insurance contracts accounting proposals?***

**A.** We welcome the high degree of convergence that could emerge from the proposals on accounting for insurance contracts. That said, we are concerned about the clear differences that would still leave comparability issues across the globe. Nevertheless, we believe that the proposals represent a positive move towards global consistency, compared with the current fragmented scenario.

There are aspects of the proposals we do not favor, e.g., they include an entirely new approach to recognizing life insurance revenue. In our view, the information produced by this approach could prove burdensome to prepare and of limited value to users. The proposals result in spreading life revenues based on future service (thereby excluding the investment component of life insurance premiums) over a defined period and "grossing up" elements of total comprehensive income. The FASB noted its intention is to make financial information of insurers more comparable with that of other businesses. In our view, the resulting revenue calculation may not accurately reflect current levels of activity or represent a metric that is useful to investors.

We believe the use of discount rates will potentially create comparability issues and equity volatility. The proposals require expected cash flows to reflect the time value of money and be discounted utilizing a rate that has characteristics of the insurance liability. In using either the top-down or bottom-up approaches outlined in the proposals, company-specific assumptions will be made that will potentially create comparability issues across companies. In addition, unlocking these assumptions every reporting period and recording changes through other comprehensive income (OCI) will potentially create volatility in equity.

Financial statement users will likely need to modify or perhaps reinvent how they analyze the financial position and performance of an insurance company. Historical financial information, benchmarks, and ratios upon which analysts typically have relied may no longer be useful or relevant.

Further, under the FASB proposal, insurers would require all changes related to future coverage or service be recognized immediately in net income. This could create volatility in the income statement and also will reflect a margin in earnings that may not be indicative of the true profit.

Although we believe that market discipline will play an important role in how insurers ultimately apply the standard's principles, we hope the IASB and FASB will provide more examples and implementation guidance, to assist insurers in preparing financial statements and users in understanding the intent behind the proposed accounting principles *(see "Global Insurance Accounting Proposals Signal Radical Change, But Fall Short Of Complete Convergence," published Oct. 16, 2013).*

## An Investor's Disclosure Wish List

**Q.** ***Many users of financial reporting information have concerns that it currently lacks completeness, consistency, and clarity of information which can impede financial analysis. What key aspects of financial services reporting do you believe warrant disclosure improvements?***

**A.** Surveyed investors told us they would like preparers to voluntarily provide—or for standard setters to consider requiring—the following disclosures in accounting standards *(see table).*

Some surveyed investors believe management should be analyzed by the way they differentiate themselves: those who provide more and better disclosure should be rewarded such as through lower cost of capital. However, some investors believe, preparers may decide the cost of increased disclosure exceeds the benefit of potentially lower cost of capital. Standard & Poor's Ratings Services acknowledges the importance of comprehensive disclosure and made suggestions in a comment letter response to the FASB on its disclosure framework proposal and in other articles *(see "The FASB's Disclosure Framework Potentially Will Change The Financial Reporting Landscape," published Dec. 7, 2012; "A Case For Greater Disclosure, Transparency, And Uniformity In U.S. Banks' Financial Reporting," published Dec. 12, 2012; and "How Enhanced Funding And Liquidity Disclosure Could Improve Confidence In The World's Banks," published May 29, 2012).*

## Beyond a Pass/Fail Opinion: An Enhanced Auditor's Report

**Q.** ***Many have suggested that the auditor's report should be expanded, to make it more relevant and useful to investors and other users of financial statements. What are your views regarding potential changes to the auditor's report to include discussion about the auditor's views on the company-based audit?***

**A.** Surveyed investors believe the current binary pass or fail audit opinion in the auditor's report falls short in providing sufficient information on significant risks within an audited entity. In general, surveyed investors view the current proposals to enhance the auditor reporting model by the Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) as positive steps towards improving transparency. The proposed PCAOB and IAASB auditor reports would communicate a more expansive set of information to investors regarding matters encountered during the audit including critical audit matters or key audit matters, respectively.

Surveyed investors noted that they expect auditors to have independence and objectivity over the audit and related information reported today and in the newly proposed auditor reports. Further, investors are concerned whether the proposed auditor report improvements, if finalized, will contain boilerplate information similar to many company financial reporting disclosures today.

**Q.** ***What are Standard & Poor's views on the PCAOB's and IAASB's audit proposals?***

**A.** We provided our views to the PCAOB and IAASB in our exposure draft comment letter response. The following are highlights of our letter.

We wholly support the efforts of the PCAOB and IAASB to increase the value of the audit and the auditor's report for analysts, investors, and other financial statement users. We believe the proposed improvements will add value to the audit, the auditor's report, and the related financial statements by disclosing potentially useful information specific to each entity that will help inform our analysis on issues identified in the audit that were significant to the auditor. This improved communication about the audit will likely enhance audit credibility and quality beyond the current pass-fail opinion, increasing usefulness and transparency for credit analysts and other financial statement users *(see our comment letter response to the PCAOB and IAASB on the proposed auditor reporting model, "Proposed Changes To The Auditor's Report May Affect Analysis," published Dec. 9, 2013, and comment letter response to the IAASB on "Improving The Auditor's Report," published Oct. 15, 2012).*

With the information and understanding gained through the audit process, the auditor has the ability to provide entity-specific information and insight beyond the binary pass-fail opinion in areas of significant risks, judgments, estimates, and assumptions. This information would be especially meaningful to credit analysts and other financial statement users if it provides relevant information that helps to better understand financial risks, including future cash flows and prospects. Financial statements are increasingly complex, so we believe users will benefit from an independent and objective view of areas where preparers applied judgments and prepared estimates, and how auditors were able to obtain sufficient, appropriate audit evidence. **CW**

For more articles on this topic search RatingsDirect with keyword:

**Financial Services**

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# RATINGS TRENDS

## Standard & Poor's Fixed Income Research

The first three pages of this section display data compiled by Standard & Poor's Global Fixed Income Research, provider of analytical and timely information on Standard & Poor's rating actions, new issuance activity, and secondary market yield spreads.

- Rating actions are tracked and analyzed. Credit trends are followed daily across seven broad industry sectors and numerous subsectors.
- New-issuance volume and pricing trends in the primary market for both investment grade and high-yield bonds in the corporate-industrial sector, telecommunication, utility, yankee, banking and financial institutions/insurance are analyzed.
- Secondary market yields and spreads for investment-grade and high yield corporate bonds are tracked and analyzed.

For additional information, contact Diane Vazza, managing director of Global Fixed Income Research at Standard & Poor's.

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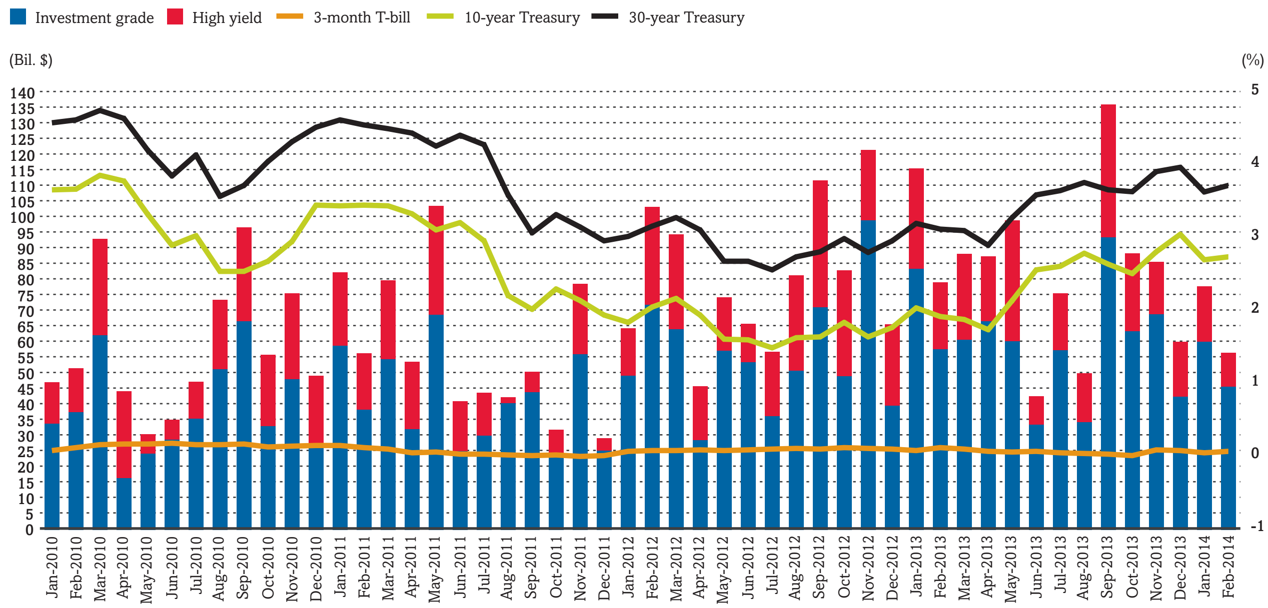
### Rating Actions

| Sector | Action | —This Week— No. | Mil. $ | —YTD 2014— No. | Mil. $ |
|---|---|---|---|---|---|
| Industrial | Upgrade | 2 | 765 | 19 | 48,019 |
| | Downgrade | 1 | 695 | 16 | 17,436 |
| Telecommunications | Upgrade | 0 | 0 | 1 | 12,150 |
| | Downgrade | 1 | 13,785 | 2 | 18,135 |
| Utility | Upgrade | 0 | 0 | 1 | 550 |
| | Downgrade | 0 | 0 | 2 | 10,725 |
| Banking | Upgrade | 0 | 0 | 0 | 0 |
| | Downgrade | 0 | 0 | 2 | 5,689 |
| Financial Institutions/Insurance | Upgrade | 0 | 0 | 0 | 0 |
| | Downgrade | 1 | 7,388 | 1 | 7,388 |
| Sovereign | Upgrade | 0 | 0 | 0 | 0 |
| | Downgrade | 1 | 187 | 4 | 33,623 |
| International | Upgrade | 1 | 272 | 12 | 39,427 |
| | Downgrade | 8 | 41,263 | 27 | 66,486 |

Data as of Feb. 19, 2014. The rating action data are for issuer credit ratings. International includes all sectors outside the U.S.
*Source: Standard & Poor's Global Fixed Income Research.*

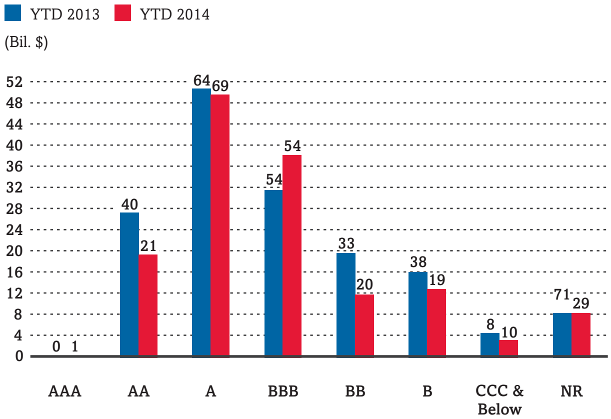
## Corporate Issuance Volume And Treasury Yields




Includes all public and Rule 144a issuance of straight debt, convertible debt, floating-rate notes, and medium-term notes by financial and nonfinancial entities into the U.S. market.
*Sources: Standard & Poor's Global Fixed Income Research, Thomson Financial.*

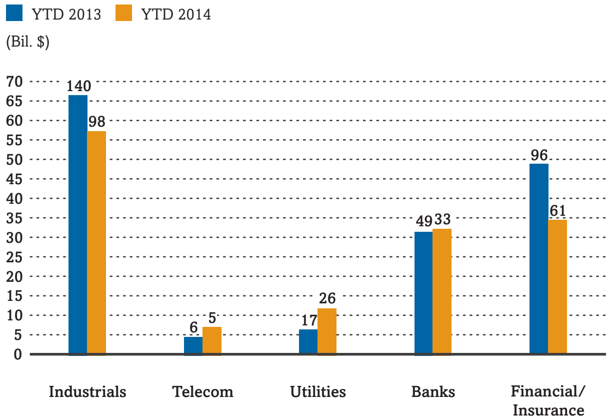
## Number Of New Issues And Dollar Volume

### By Rating Category




Includes all public and Rule 144a issuance of straight debt, convertible debt, floating-rate notes, and medium-term notes by financial and nonfinancial entities into the U.S. market.
*Sources: Standard & Poor's Global Fixed Income Research, Thomson Financial.*

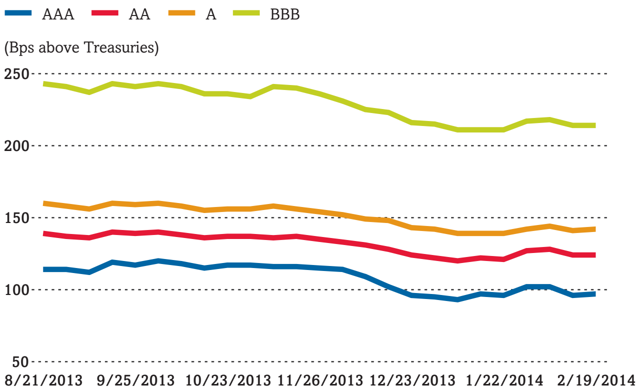
### By Sector




Includes all public and Rule 144a issuance of straight debt, convertible debt, floating-rate notes, and medium-term notes by financial and nonfinancial entities into the U.S. market.
*Sources: Standard & Poor's Global Fixed Income Research, Thomson Financial.*

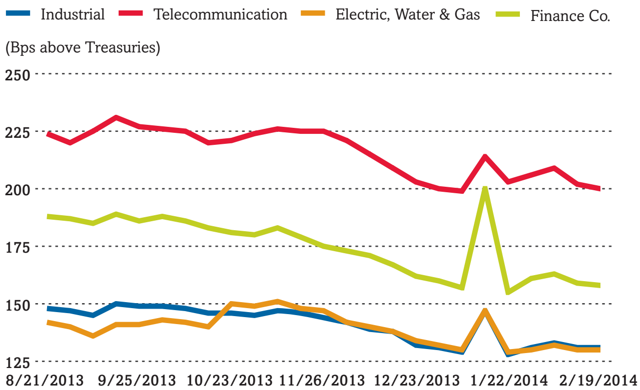
## Spread To Treasuries By Rating Category

### U.S. Industrial Credit Trends By Rating Category



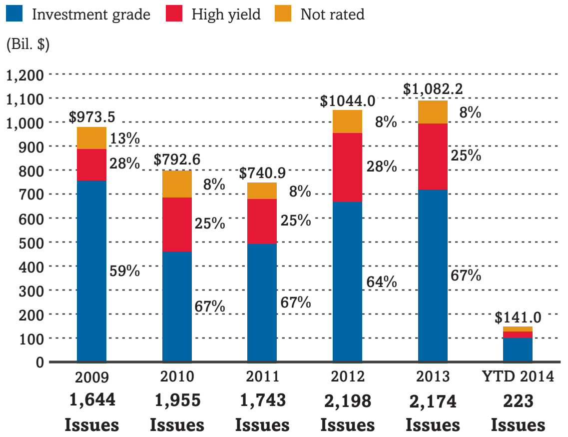

Includes Yankee bond issues. Nine plus years to maturity and minimum $100 million outstanding.
*Source: Standard & Poor's Global Fixed Income Research.*

### Sector Relative Value Rating Category 'A'



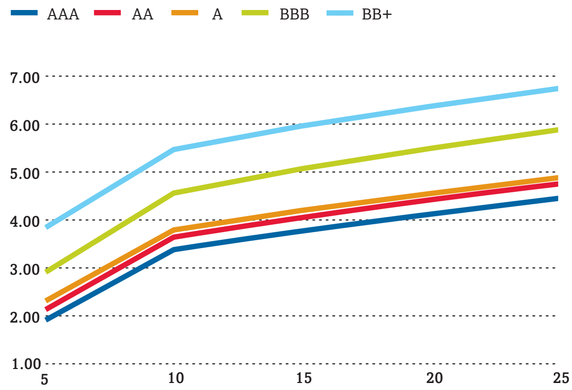

Five plus years to maturity and minimum $100 million outstanding.
*Source: Standard & Poor's Global Fixed Income Research.*

## U.S. Corporate Bond Issuance




Includes all public and Rule 144a issuance of straight debt, convertible debt, floating-rate notes, and medium-term notes by financial and nonfinancial entities into the U.S. market.
*Sources: Standard & Poor's Global Fixed Income Research, Thomson Financial.*

## U.S. Industrial Bond Yields




Data as of Feb. 19, 2014.
*Source: Standard & Poor's Global Fixed Income Research.*

## Macroeconomic Data From *Global Insight*

*Global Insight* is a leading provider of financial and economic information used by industry, government, and financial institutions to assess business conditions and monitor emerging trends.

☎ For additional information on *Global Insight* products and services, call Charles Ferrari (1) 212-884-9518.

### Wholesale Price Inflation (% Change-1 Yr.)

| | Jan-2014 | Dec-2013 | Nov-2013 |
|---|---|---|---|
| U.S. | 1.09 | 1.08 | 1.08 |
| U.K. | 1.98 | 1.96 | 1.96 |
| Germany | 1.07 | 1.07 | 1.07 |
| Japan | 1.01 | 1.01 | 1.01 |

Data presented as monthly averages.
*Source: Global Insight.*

### Long-Term Bond Rates (%)

| | This week | One week ago | One year ago |
|---|---|---|---|
| U.S. | 2.73 | 2.76 | 2.00 |
| U.K. | 2.80 | 2.79 | 2.27 |
| Germany | 1.69 | 1.68 | 1.61 |
| Japan | 0.61 | 0.61 | 0.75 |

### Short-Term Interest Rates (%)

| | This week | One week ago | One year ago |
|---|---|---|---|
| U.S. | 0.19 | 0.19 | 0.17 |
| U.K. | 0.38 | 0.38 | 0.41 |

Data presented as weekly averages. Germany is current yield. Other data are yield to maturity. *Source: Global Insight.*
Data for German and Japanese short-term bond rates have been discontinued.

## Standard & Poor's Rated U.S. Money Fund Indices

| | 7-Day net yield (%) | 30-Day net yield (%) | 7-Day gross yield (%) | 30-Day gross yield (%) | Maturity (days) | Total assets (bil. $) |
|---|---|---|---|---|---|---|
| **Money Fund Indices (Period ended 2/18/2014)** | | | | | | |
| 'AAAm'/Government | 0.01 | 0.01 | N.A. | N.A. | 47 | N.A. |
| 'AAAm'/Taxable | 0.01 | 0.01 | N.A. | N.A. | 46 | N.A. |
| 'AAAm'/Tax-Free | 0.02 | 0.02 | N.A. | N.A. | 26 | N.A. |
| **Government Investment Pool (GIP) Indices* (Period ended 2/14/2014)** | | | | | | |
| GIP Index/All | 0.05 | 0.05 | 0.15 | 0.14 | 49 | 101.6 |
| GIP Index/Government | 0.02 | 0.02 | 0.10 | 0.10 | 49 | 31.8 |
| GIP Index/General Purpose Taxable | 0.05 | 0.05 | 0.16 | 0.16 | 49 | 69.7 |

*Comprised of 'AAAm' and 'AAm' rated government investment pools. N.A.–Not available. *Sources: Standard & Poor's; Rated Money Fund Report, a service of iMoneyNet, Inc.*

# SOVEREIGN LIST

## Sovereign Ratings And Country T&C Assessments

Standard & Poor's Ratings Services currently rates 129 sovereign governments and has established transfer and convertibility (T&C) assessments for each country with a rated sovereign, as shown in the table below. A T&C assessment is the rating associated with the likelihood of the sovereign restricting nonsovereign access to foreign exchange needed for debt service. For most countries, Standard & Poor's analysis concludes that this risk is less than the risk of sovereign default on foreign-currency obligations; thus, most T&C assessments exceed the sovereign foreign currency rating. Foreign currency ratings of nonsovereign entities or transactions generally can be as high as the T&C assessment if their stress-tested operating and financial characteristics support the higher rating. For more information, please see *"Corporate And Government Ratings That Exceed The Sovereign Rating,"* published monthly on *RatingsDirect*.

If a sovereign, through membership in a monetary or currency union, has ceded monetary and exchange rate policy responsibility to a monetary authority that the sovereign does not solely control, the T&C assessment reflects the policies of the controlling monetary authority, vis-à-vis the exchange of its currency for other currencies in the context of debt service. The same applies if a sovereign uses as its local currency the currency of another sovereign. A T&C assessment may change sharply if a sovereign introduces a new local currency, by entering or exiting a monetary/currency union, or through some other means. This is because the new local currency, and in some cases the new monetary authority, may operate in very different monetary and exchange regimes. The T&C assessment does not normally reflect the likelihood of change in a country's local currency.

For historical information on these ratings and assessments, please see *"Sovereign Rating And Country T&C Assessment Histories,"* published monthly on *RatingsDirect*. Ratings as of February 7, 2014. **CW**

| | —SOVEREIGN RATINGS (LT/OUTLOOK/ST)— | | TRANSFER & CONVERTIBILITY |
|---|---|---|---|
| COUNTRY | LOCAL CURRENCY | FOREIGN CURRENCY | ASSESSMENT |
| Abu Dhabi | AA/Stable/A-1+ | AA/Stable/A-1+ | AA+* |
| Albania | B/Negative/B | B/Negative/B | BB- |
| Andorra | A-/Negative/A-2 | A-/Negative/A-2 | AAA* |
| Angola | BB-/Stable/B | BB-/Stable/B | BB- |
| Argentina | CCC+/Negative/C | CCC+/Negative/C | CCC+ |
| Aruba | BBB+/Stable/A-2 | BBB+/Stable/A-2 | BBB+ |
| Australia | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Austria | AA+/Stable/A-1+ | AA+/Stable/A-1+ | AAA* |
| Azerbaijan | BBB-/Stable/A-3 | BBB-/Stable/A-3 | BBB- |
| Bahamas | BBB/Negative/A-2 | BBB/Negative/A-2 | BBB+ |
| Bahrain | BBB/Stable/A-2 | BBB/Stable/A-2 | BBB |
| Bangladesh | BB-/Stable/B | BB-/Stable/B | BB- |
| Barbados | BB-/Negative/B | BB-/Negative/B | BB- |
| Belarus | B-/Stable/B | B-/Stable/B | B- |
| Belgium | AA/Negative/A-1+ | AA/Negative/A-1+ | AAA* |
| Belize | B-/Stable/B | B-/Stable/B | B- |
| Bermuda | AA-/Negative/A-1+ | AA-/Negative/A-1+ | AAA |
| Bolivia | BB-/Stable/B | BB-/Stable/B | BB- |
| Bosnia and Herzegovina | B/Stable/B | B/Stable/B | BB- |
| Botswana | A-/Stable/A-2 | A-/Stable/A-2 | A+ |
| Brazil | A-/Negative/A-2 | BBB/Negative/A-2 | A- |
| Bulgaria | BBB/Negative/A-2 | BBB/Negative/A-2 | A |

| COUNTRY | —SOVEREIGN RATINGS (LT/OUTLOOK/ST)— LOCAL CURRENCY | FOREIGN CURRENCY | TRANSFER & CONVERTIBILITY ASSESSMENT |
|---|---|---|---|
| Burkina Faso | B/Stable/B | B/Stable/B | BBB-* |
| Cambodia | B/Stable/B | B/Stable/B | B+ |
| Cameroon | B/Stable/B | B/Stable/B | BBB-* |
| Canada | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Cape Verde | B/Stable/B | B/Stable/B | BB- |
| Chile | AA+/Stable/A-1+ | AA-/Stable/A-1+ | AA+ |
| China | AA-/Stable/A-1+ | AA-/Stable/A-1+ | AA- |
| Colombia | BBB+/Stable/A-2 | BBB/Stable/A-2 | A- |
| Congo-Brazzaville | B+/Stable/B | B+/Stable/B | BBB-* |
| Congo-Kinshasa | B-/Stable/B | B-/Stable/B | B |
| Cook Islands | B+/Stable/B | B+/Stable/B | AAA* |
| Costa Rica | BB/Stable/B | BB/Stable/B | BBB- |
| Croatia | BB/Stable/B | BB/Stable/B | BBB |
| Curacao | A-/Stable/A-2 | A-/Stable/A-2 | A- |
| Cyprus | B-/Stable/B | B-/Stable/B | AAA* |
| Czech Republic | AA/Stable/A-1+ | AA-/Stable/A-1+ | AA+ |
| Denmark | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Dominican Republic | B+/Stable/B | B+/Stable/B | BB |
| Ecuador | B/Positive/B | B/Positive/B | B |
| Egypt | B-/Stable/B | B-/Stable/B | B- |
| El Salvador | BB-/Negative/B | BB-/Negative/B | AAA* |
| Estonia | AA-/Stable/A-1+ | AA-/Stable/A-1+ | AAA* |
| Fiji | B/Stable/B | B/Stable/B | B |
| Finland | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA* |
| France | AA/Stable/A-1+ | AA/Stable/A-1+ | AAA* |
| Gabon | BB-/Stable/B | BB-/Stable/B | BBB-* |
| Georgia | BB-/Stable/B | BB-/Stable/B | BB |
| Germany | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA* |
| Ghana | B/Negative/B | B/Negative/B | B+ |
| Greece | B-/Stable/B | B-/Stable/B | AAA* |
| Grenada | SD/NM/SD | SD/NM/SD | BBB-* |
| Guatemala | BB+/Stable/B | BB/Stable/B | BBB- |
| Honduras | B/Stable/B | B/Stable/B | B+ |
| Hong Kong | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Hungary | BB/Negative/B | BB/Negative/B | BBB- |
| Iceland | BBB-/Stable/A-3 | BBB-/Stable/A-3 | BBB- |
| India | BBB-/Negative/A-3 | BBB-/Negative/A-3 | BBB+ |
| Indonesia | BB+/Stable/B | BB+/Stable/B | BBB- |
| Ireland | BBB+/Positive/A-2 | BBB+/Positive/A-2 | AAA* |
| Isle of Man | AA+/Stable/A-1+ | AA+/Stable/A-1+ | AAA* |

# SOVEREIGN LIST

| COUNTRY | —SOVEREIGN RATINGS (LT/OUTLOOK/ST)— LOCAL CURRENCY | FOREIGN CURRENCY | TRANSFER & CONVERTIBILITY ASSESSMENT |
|---|---|---|---|
| Israel | A+/Stable/A-1 | A+/Stable/A-1 | AA |
| Italy | BBB/Negative/A-2 | BBB/Negative/A-2 | AAA* |
| Jamaica | B-/Stable/B | B-/Stable/B | B |
| Japan | AA-/Negative/A-1+ | AA-/Negative/A-1+ | AAA |
| Jersey | AA+/Stable/A-1+ | AA+/Stable/A-1+ | AAA |
| Jordan | BB-/Negative/B | BB-/Negative/B | BB+ |
| Kazakhstan | BBB+/Stable/A-2 | BBB+/Stable/A-2 | BBB+ |
| Kenya | B+/Stable/B | B+/Stable/B | BB- |
| Korea | AA-/Stable/A-1+ | A+/Stable/A-1 | AA |
| Kuwait | AA/Stable/A-1+ | AA/Stable/A-1+ | AA+ |
| Latvia | BBB+/Positive/A-2 | BBB+/Positive/A-2 | AAA* |
| Lebanon | B-/Negative/B | B-/Negative/B | B+ |
| Liechtenstein | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA* |
| Lithuania | BBB/Positive/A-2 | BBB/Positive/A-2 | A |
| Luxembourg | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA* |
| Macedonia | BB-/Stable/B | BB-/Stable/B | BB |
| Malaysia | A/Stable/A-1 | A-/Stable/A-2 | A+ |
| Malta | BBB+/Stable/A-2 | BBB+/Stable/A-2 | AAA* |
| Mexico | A/Stable/A-1 | BBB+/Stable/A-2 | A+ |
| Mongolia | BB-/Negative/B | BB-/Negative/B | BB |
| Montenegro | BB-/Negative/B | BB-/Negative/B | AAA* |
| Montserrat | BBB-/Stable/A-3 | BBB-/Stable/A-3 | BBB-* |
| Morocco | BBB-/Negative/A-3 | BBB-/Negative/A-3 | BBB+ |
| Mozambique | B+/Negative/B | B+/Negative/B | B+ |
| Netherlands | AA+/Stable/A-1+ | AA+/Stable/A-1+ | AAA* |
| New Zealand | AA+/Stable/A-1+ | AA/Stable/A-1+ | AAA |
| Nigeria | BB-/Stable/B | BB-/Stable/B | BB- |
| Norway | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Oman | A/Stable/A-1 | A/Stable/A-1 | AA- |
| Pakistan | B-/Stable/B | B-/Stable/B | B- |
| Panama | BBB/Stable/A-2 | BBB/Stable/A-2 | AAA* |
| Papua New Guinea | B+/Stable/B | B+/Stable/B | BB |
| Paraguay | BB-/Stable/B | BB-/Stable/B | BB |
| Peru | A-/Stable/A-2 | BBB+/Stable/A-2 | A |
| Philippines | BBB-/Stable/A-3 | BBB-/Stable/A-3 | BBB |
| Poland | A/Stable/A-1 | A-/Stable/A-2 | A+ |
| Portugal | BB/Negative/B | BB/Negative/B | AAA* |
| Qatar | AA/Stable/A-1+ | AA/Stable/A-1+ | AA+ |
| Ras Al Khaimah | A/Stable/A-1 | A/Stable/A-1 | AA+* |
| Romania | BB+/Positive/B | BB+/Positive/B | BBB+ |

| COUNTRY | —SOVEREIGN RATINGS (LT/OUTLOOK/ST)— LOCAL CURRENCY | FOREIGN CURRENCY | TRANSFER & CONVERTIBILITY ASSESSMENT |
|---|---|---|---|
| Russia | BBB+/Stable/A-2 | BBB/Stable/A-2 | BBB |
| Rwanda | B/Stable/B | B/Stable/B | B |
| Saudi Arabia | AA-/Positive/A-1+ | AA-/Positive/A-1+ | AA+ |
| Senegal | B+/Stable/B | B+/Stable/B | BBB-* |
| Serbia | BB-/Negative/B | BB-/Negative/B | BB- |
| Sharjah | A/Stable/A-1 | A/Stable/A-1 | AA+ |
| Singapore | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Slovak Republic | A/Stable/A-1 | A/Stable/A-1 | AAA* |
| Slovenia | A-/Stable/A-2 | A-/Stable/A-2 | AAA* |
| South Africa | A-/Negative/A-2 | BBB/Negative/A-2 | A- |
| Spain | BBB-/Stable/A-3 | BBB-/Stable/A-3 | AAA* |
| Sri Lanka | B+/Stable/B | B+/Stable/B | B+ |
| Suriname | BB-/Positive/B | BB-/Positive/B | BB |
| Sweden | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Switzerland | AAA/Stable/A-1+ | AAA/Stable/A-1+ | AAA |
| Taiwan | AA-/Stable/A-1+ | AA-/Stable/A-1+ | AA+ |
| Thailand | A-/Stable/A-2 | BBB+/Stable/A-2 | A |
| Trinidad and Tobago | A/Stable/A-1 | A/Stable/A-1 | AA |
| Turkey | BBB/Negative/A-2 | BB+/Negative/B | BBB |
| Uganda | B/Stable/B | B/Stable/B | B |
| Ukraine | B-/Negative/B | CCC+/Negative/C | CCC+ |
| United Kingdom | AAA/Negative/A-1+ | AAA/Negative/A-1+ | AAA |
| United States | AA+/Stable/A-1+ | AA+/Stable/A-1+ | AAA |
| Uruguay | BBB-/Stable/A-3 | BBB-/Stable/A-3 | BBB+ |
| Venezuela | B-/Negative/B | B-/Negative/B | B- |
| Vietnam | BB-/Stable/B | BB-/Stable/B | BB- |
| Zambia | B+/Negative/B | B+/Negative/B | B+ |

*These T&C assessments are for countries that are either members of monetary or currency unions or use as their local currency the currency of another sovereign. Because of this, the assessment shown is based on Standard & Poor's analysis of either the monetary authority of the monetary/currency union or the sovereign issuing the currency. Thus, for European Economic and Monetary Union (EMU) members (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, Netherlands, Portugal, Slovak Republic, Slovenia, and Spain), the T&C assessments reflect our view of the likelihood of the European Central Bank restricting nonsovereign access to foreign exchange needed for debt service. Similarly, the T&C assessments for countries with rated sovereigns in the Eastern Caribbean Currency Union (Grenada and Montserrat) reflect the current and projected policies of the Eastern Caribbean Central Bank. Likewise, the T&C assessments for countries with rated sovereigns in the West African Economic and Monetary Union (Burkina Faso and Senegal) are based on the policies of the Central Bank of West African States, and the T&C assessments for countries with rated sovereigns in the Central African Economic and Monetary Community (Cameroon, Congo-Brazzaville, and Gabon) are based on the policies of the Bank of Central African States. As for countries that use the currency of another, the T&C assessments of El Salvador and Panama are equalized with that of the U.S., while those of Abu Dhabi and Ras Al Khaimah are equalized with that of the United Arab Emirates, Andorra and Montenegro with EMU members, the Cook Islands with New Zealand, the Isle of Man with the U.K., and Liechtenstein with Switzerland.

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