Financial Statement Adjustments for Corporates

Request for Comments

Purpose

Lianhe Ratings Global Limited's ("Lianhe Global") general corporate criteria were originally published on 16 July 2018. Lianhe Global recognizes there are differences in financial reporting standards among regions and industries. We strive to standardize these differences for the sake of comparability of financial data and consistency of our credit analysis. Thus, we make appropriate financial statement adjustments and outline the standard adjustments in this report. These are common and standard adjustments, and analysts will make other non-standard reclassifications and adjustments as they see fit to account for unique circumstances.

Lianhe Global invites market participants to provide comments and feedback on the proposed criteria by 31 March 2022 by submitting their comments and feedback to info@lhratingsglobal.com.

No changes to our existing ratings are expected to result from the publication of the criteria, as it primarily relates to further supplement to and elaboration of the general corporate criteria published on 31 December 2021.

Scope of the Criteria

Lianhe Global applies the criteria to corporate entities that are not in the industry of banking, non-bank finance, regulated monopolies (i.e. utilities), not-for-profit, or those providing public and government services.

The criteria do not represent a comprehensive coverage but only address key rating factors to form our credit opinions and will be reviewed periodically. Credit opinions tend to be forward-looking and include our views of issuers' future performance and development.

Financial Statement Adjustments

Capitalized Interest Expenses

An obligor borrows funds to develop and construct current and/or non-current assets and choose to capitalize the related interest portion as a part of the cost of the assets. This gives the appearance that the obligor has either a lower cost of funding or lesser interest expenses. For comparability purpose of interest coverage analysis, we consider all interest costs including both interest expenses on income statement and capitalized interest as an asset on balance sheet.

Therefore, we reclassify all capitalized interest as interest expense.

Capitalized Development Costs

An obligor incurs sizeable research and development ("R&D") costs and it may choose to capitalize them instead of expensing them. It is challenging to determine if the capitalized R&D costs would lead to commercially successful products and/or services.

For conservative and comparability purposes, we reclassify capitalized development costs as expenses.

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Leases

We reclassify any non-cancellable operating lease as debt, if it has not already been accounted under IFRS 16. In other words, we consider operating lease similar to the treatment of finance lease. We reclassify rental expense into imputed (a) interest expense and (b) depreciation expense. The imputed interest is added to the interest expense. Then, we add the present value of minimum lease payments as the carrying amount of a fixed asset and its corresponding debt on the balance sheet. We will assume an appropriate discount rate for such obligor to estimate the present value of minimum lease payments.

Thus, this reclassification would increase the interest expense, depreciation expense, debt and fixed assets.

Financial Guarantees

This is a common practice where an obligor provides guarantees to its non-consolidated subsidiaries or third-parties to lower the borrowing costs for them. In an event of non-payment, the obligor or the guarantor has to make the guaranteed payment. We normally regard these guarantees as debt.

In general, we reclassify financial guarantees as debt in the absence of detailed information.

Securitizations and Factoring for Receivables

Factoring refers to the sale of an obligor's receivables to a third-party entity or a factor in return for funding either with or without recourse. It will help the obligor to obtain cash and improve its financial ratios. However, in an event of non-payment of the receivables, the factor with recourse could put the receivables back to the obligor. Thus, we reclassify factoring with a recourse to an obligor as debt.

Securitization refers to the pooling of an obligor's receivables, followed by the selling of related cash flows to third-party entity as securities. In general, we do not include securitizations as debt unless we determine there is a heightened risk of clawback in the subject's jurisdiction.

Hybrid Capital

Hybrid securities encompass both debt-like and equity-like features. As a rule of thumb, analysts will determine the liability components of the securities and then calculate the residual value, or equity component, which is the difference between the market value of the securities and the liability components. Then, we will reclassify them according to their respective equity or debt features.

In the absence of detailed information, we reclassify hybrid securities as debt. In general, we examine the features of hybrid securities, such as (a) method of settlement, (b) deferment of payment, (c) maturity date, and (d) priority of claim etc, to reclassify them.

The table below provides a guidance for analysts to determine their weights:

Hybrid Features	Debt-Like	In-Between			Equity-Like
Method of Settlement	Cash				Equity
Coupon Omission / Deferral	Optional deferral with constraints, mandatory deferral with low triggers				Optional deferral with full discretion, mandatory deferral with tight triggers
Settlement	Cumulative				Non-cumulative
Maturity Date	<=5 years				
Priority of Claim	Senior				Junior
Coupon step-up	Call dates within next 5 years and aggregate step-ups >=100 bps				
Covenant or event of default					No covenants, no acceleration rights, no right to declare default or an event of default, etc.
Debt Weight	100%	75%	50%	25%	0%
Equity Weight	0%	25%	50%	75%	100%

Defined Benefit Pension Plans

In general, we regard any unfunded or underfunded defined benefit employee retirement obligations as debt of an obligor. These unfunded or underfunded pension obligations represent obligor's outstanding financial obligations to its pension trust that is not covered by its benefit plan assets.

Therefore, we reclassify such unfunded or underfunded pension obligations as debt. Analysts will also determine if assumptions made by an obligor in calculating its pension liabilities and their matching investments or provisions are sound and reasonable. Analysts may make adjustments as they see fit.

Asset Retirement Obligations (ARO)

Asset Retirement Obligations ("AROs") generally refer to costs associated with the retirement of non-current assets most commonly associated with restoration of land for mining and oil & gas exploration. An obligor is required to recognize a provision for these non-cancellable costs.

As a result, we reclassify these AROs as debt. In case an obligor has proven to have sufficient reserve fund or silo for these AROs, we will not make any reclassification.

Litigations

An obligor involves in any litigation, either as a plaintiff or defendant, may incur not only judgment payment but also legal expenses. It is challenging to determine the outcomes of

any legal proceeding. As a result, an obligor has to make provision on its financial statements. Some portions of these provisions could be reversed based on the outcomes of legal proceedings.

For conservative purpose, we reclassify such provisions for litigations as debt.

Total Debt

In view of the reclassifications mentioned above, we adjust the following items on top of obligor's reported debt to constitute its total debt: carrying amount of present value of minimum lease payments or finance lease liabilities, financial guarantees, factoring of receivables with a recourse, hybrid instrument treated as debt, unfunded/underfunded pension obligations, AROs, provisions for litigations and deferred tax liabilities.

Ratio Definitions

Debt

We reclassify any non-cancellable financial obligation with a defined coupon and maturity as debt. Therefore, we define Debt as the sum of (a) short-term debt, (b) current portion of long-term debt, (c) long-term debt (net of current portion), (d) plus any adjustment and reclassification stated herein.

Liquid Assets

We define Liquid Assets as unrestricted cash (i.e. restricted cash and pledged deposit are excluded), marketable short-term securities and foreign currencies, and other adjustments and reclassifications.

Net Debt

We define Net Debt as Debt minus Liquid Assets.

Equity

We define Equity as shareholders' equity plus any adjustment and reclassification stated herein.

Capitalization

We define Capitalization as the sum of Debt and Equity.

Gross Profit

We define Gross Profit as revenue minus cost of goods sold (COGS). We exclude depreciation expenses and amortization costs in calculating COGS.

Interest Expense

We define Interest Expense as gross interest expense plus reclassified interests, but exclude interest income unless such interest income is recurring in nature.

EBITDA

We define EBITDA as revenue minus COGS, operating expenses, plus depreciation expenses and amortization costs, and capitalized interest under COGS. We only take into account of recurring revenue and incomes such as interest incomes and cash dividends received etc. If capitalized interest under COGS is not available or consistently disclosed, we may use the capitalized interest under finance cost as a proxy for such.

In certain cases, we will examine, including but not limited to, the following ratios as part of the reference for our analysis:

Funds from Operations (FFO)

We define FFO as EBITDA minus Interest Expense, current tax expense, and plus interest and dividend income.

Cash Flow from Operations (CFO)

We define CFO as FFO plus the change in working capital.

Free Operating Cash Flow (FOCF)

We define FOCF as CFO minus capital expenditure.

Discretionary Cash Flow (DCF)

We define DCF as FOCF minus cash dividend paid and cash contributions for equity-like instruments.

Commonly Used Financial Ratios

Debt Coverage

Debt / EBITDA

We believe Debt Coverage ratio as measured by Debt over EBITDA is a good yardstick to measure debt coverage across industry. This ratio excludes implications from (1) interest costs due to different level of capital structure, (2) tax rates due to both capital structure (i.e. tax savings on debt if applicable) and income tax brackets, and (3) various rates on depreciation, depletion, and amortization schedules, across industry. This ratio measures the number of years it will take a corporate entity to repay its debt given its current and expected earning power (EBITDA). The lower the number is, the lower the leverage becomes and the higher the coverage on debt by EBITDA is.

Interest Coverage

EBITDA / Interest Expense

Interest Coverage ratio as measured by EBITDA over Interest Expense measures the margin of safety of a corporate entity to cover its interest obligation given its current and expected earning power (EBITDA). The higher the number is, the stronger the coverage on interest expense by EBITDA is.

Financial Leverage

Debt / Capitalization

Financial Leverage ratio as measured by Debt over Capitalization measures the capital structure of a corporate entity. The higher the number is, the higher the burden to repay debt is.

However, the higher the financial leverage is, some investors view it as the higher the expected return favoring equity investors is. Also, different industries have different capital structures, and often time it is challenging to compare and contrast their financial leverage ratios directly.

Quick Ratio

(Liquid Assets + Receivables) / Current Liabilities

We measure the internally generated liquidity of a corporate entity by examining its Quick Ratio. Quick Ratio measures the ability of a corporate entity to pay off its current liabilities in the short term. The higher the number is, the higher the liquidity is. Nevertheless, we do not have a predetermined absolute scale for the quick ratio, as it varies from industry to industry.

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