DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies

This criteria contains a list of financial ratios used by DBRS and includes a discussion of the adjustments made to the accounting data to permit ratio comparability. The ratios are grouped by type and industry sector (see below) and the ratio definitions start on page 2. The definitions of the terms used in the ratios start on page 3. Lastly, the discussion of the various accounting treatments and adjustments starts on page 5. The ratios and financial statement adjustments discussed in this criteria are those generally applied by DBRS. Variations from these ratio definitions or accounting treatments may on occasion arise, owing to industry or issuer-specific factors, questions of materiality or other factors. In order to provide clarity for investors, DBRS will generally note such variations in the issuer’s rating report.

Financial Ratios and Definitions

I. Ratio Groupings

| Ratios: | Industry Specific Ratios$^1$ |
|---------------------|---------------------|---------------------|---------------------|---------------------|
| A. Retailing | B. Real Estate | C. Utilities & Pipelines | D. Mining |
| 1. Gross margin | | | |
| 2. EBITDA margin | | | |
| 3. EBIT margin | | | |
| 4. Net margin | | | |
| 5. EBITDA interest coverage | 5a | | |
| 6. EBIT interest coverage | 6a | | |
| 7. Fixed-charge coverage | | | |
| 8. DSCR | 8c | | |
| 9. Debt / CFADS | | | |
| 10. Debt / EBITDA | 10a | | |
| 11. Return on equity | | 11b | |
| 12. Return on capital | | 12b | |
| 13. Return on assets | | 13b | |
| 14. Debt / equity | | | |
| 15. Debt / capital | 15a. | | |
| 16. Net debt / capital | | | |
| 17. Asset coverage | | | |
| 18. Asset turnover | | | |
| 19. Current ratio | | 19d | |
| 20. Current assets / total assets | | | |
| 21. Accounts payable / inventory | | | |
| 22. Quick ratio | | 22d | |
| 23. Inventory turnover days | | | |
| 24. Receivable turnover days | | | |
| 25. Payable turnover days | | | |
| 26. Acc. deprec. / fixed assets | | | |
I. Ratio Groupings

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1. Ratios not listed here will where necessary be footnoted in reports to ensure clarity.

II. Ratio Definitions

1. Gross margin = gross profit / revenue
2. EBITDA margin = EBITDA / revenue
3. EBIT margin = EBIT / revenue
4. Net margin = core net income before minority interest / revenue
5. EBITDA interest coverage = EBITDA / Gross interest expense (assumes operating leases are not material)
5a EBITDAR interest coverage = EBITDAR / gross interest expense + operating lease interest expense
6. EBIT interest coverage = EBIT / gross interest expense (assumes operating leases are not material)
6a EBITR interest coverage = EBIT + operating lease interest expense / (gross interest expense + operating lease interest expense)
7. Fixed-charge coverage = EBIT + operating lease interest expense / (gross interest expense + operating lease interest expense + preferred dividends (tax adjusted))
8. DSCR for projects = (revenue - cash operating expense - income tax - maintenance capex) / (interest expense + principal amortization)
8c DSCR for utilities = (revenue - cash operating expense - cash taxes) / (interest expense + principal amortization)
9. Debt / CFADS = total debt / EBITDA before taxes and after maintenance capex
10. Debt / EBITDA = total debt / EBITDA (assumes operating leases are not material)
10a Adjusted debt / EBITDAR = total adjusted debt / EBITDAR
11. Return on equity = core net income after minority interest / average common equity
11b Cash return on equity = cash flow from operations / average common equity
12. Return on capital = EBIT (1 - tax rate) / average total capital
12b Cash return on capital = cash flow from operations / average total capital
13. Return on assets = EBIT (1-tax rate) / average total assets
13b Cash return on assets = cash flow from operations / average total assets
14. Debt / equity = total debt / total equity
15. Debt / capital = total debt / total capital
15a. Adjusted debt / capital = total adjusted debt / total adjusted capital
II. Ratio Definitions

16. Net debt / capital = (total debt - cash) / (total capital - cash)
17. Asset coverage = (total assets - goodwill - future tax liability - deferred credits - minority interest - current liabilities + current portion of long-term debt + short-term debt) / total debt.
18. Asset turnover = total revenue / average total assets
19. Current ratio = current assets / current liabilities
19d Current ratio, adjusted = non-monetary current assets / non-monetary current liabilities
20. Current assets / total assets = current assets / total assets
21. Accounts payable / inventory = accounts payable / inventory
22. Quick ratio = (cash + receivables) / (total current liabilities)
22d Quick ratio, adjusted = (Cash + receivables + inventory) / (short-term debt)
23. Inventory turnover days = 365 (average inventories / cost of goods sold)
24. Receivable turnover days = 365 (average account receivables / revenues excluding)
25. Payable turnover days = 365 (average accounts payable / cost of goods sold)
26. Acc. deprec. / fixed assets = accumulated depreciation / gross fixed assets
27. Cash flow / interest = (cash flow from operations + after-tax interest expense) / after-tax interest expense
28. Cash flow / debt = cash flow from operations / total debt (assumes operating leases are not material)
28a Adjusted cash flow / total debt = cash flow from operations + after-tax operating lease non-interest expense / (total debt + capitalized operating leases)
29. Cash flow / capex = cash flow from operations / capex
30. Cash flow - dividends / capex = cash flow from operations - preferred dividends - common dividends / capex
31. Depreciation / capex = depreciation / reported capex
31d Capex / depreciation, adjusted = reported capex / (depreciation + amortization + deprecation)
32. Capex / revenue = capex / revenue
33. Cash / capex = cash / capex
34. Common dividend payout ratio = common dividends / core net income, less preferred dividends and minority interest
35. Total dividend payout ratio = common and preferred dividends / core net income, less minority interest
36. Common dividend / cash flow = common dividends / cash flow from operations
37. Distribution payout ratio = distribution / cash flow available for distribution

III. Ratio Term Definitions

1. Amortization = reported amortization of goodwill & intangible assets
2. Assets, total = reported current and long-term assets
3. Assets, tangible = total assets - goodwill - intangible assets
4. Capex = reported capital expenditures
5. Capital, total = total debt + total preferred equity + total common equity + minority interest+ capital leases
6. Capital leases = all non-operating leases that are capitalized on the balance sheet
7. Capital, adjusted = total capital + capitalized operating leases
8. Cash = cash & cash equivalents + short-term investments
9. Cash flow from operations = core net income + depreciation + amortization + deferred taxes + other non-cash items from income statement (before capex and changes in non-cash working capital)

1. All numbers are to be annualized and normalized where applicable.
2. All ratios include the assets and income of any minority interests. Minority interests are included in total capital. When minority interests are removed from total capital and net income the numbers and ratios must be properly annotated.
3. Debt can also include off-balance sheet financing (see Off-Balance Sheet Items section on page 10 for further information). Ratios including this debt number would be separate and annotated.
Criteria

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III. Ratio Term Definitions

10. **Cash flow available for distribution** = cash flow from operations - maintenance capex - leasing costs (before working capital)
11. **Cash flow, free** = cash flow from operations - capex - dividends - change in non-cash working capital
12. **Cash flow, free, before change in w/c** = cash flow from operations - capex - dividends
13. **Cost of goods sold** = costs incurred in production before depreciation
14. **Debt, total** = short-term debt + long-term debt + hybrid debt portion + capital leases
15. **Debt, net** = total debt - cash
16. **Debt, short-term** = notes/short-term debt + current portion of long-term debt
17. **Debt, long-term** = total debt - short-term debt
18. **Debt, adjusted** = total debt + capitalized operating leases
19. **Debt, hybrid** = debt securities with equity-like features
20. **Depreciation** = reported depreciation
21. **Depletion** = reported amortization of value of resource property
22. **Dividends, common** = reported common dividends
23. **Dividends, total** = common dividends + preferred dividends + special dividends
24. **Distribution** = amounts paid out to unit holders (usually from income trusts, REITs and MLPs)
25. **EBITDA** = revenue - cost of good sold - SG&A
26. **EBITDAR** = EBITDA + operating lease expense
27. **EBITDA, cash** = EBITDA excluding non-cash items
28. **EBIT** = EBITDA - depreciation - amortization
29. **Equity, common** = common shares + retained earnings + additional paid in capital
30. **Equity, total** = common equity + preferred equity + hybrid equity portion
31. **Gross profit** = revenue - cost of goods sold
32. **Hybrids** = debt hybrids + other securities with equity-like features
33. **Interest expense, gross** = all interest expense + debt hybrid interest expense + capitalized interest (exclude any IFRS adjustments)
34. **Interest expense, net** = gross interest expense - interest income from cash and short-term investments
35. **Interest income** = interest and investment income
36. **Inventory** = reported inventory including materials and finished product
37. **Lease adjusted debt** = total debt + capitalized operating leases
38. **Leasing costs** = tenant inducements, etc
39. **Minority interest** = ownership by others of consolidated subsidiaries (including common shares and preferred shares)
40. **Minority interest in earnings** = minority interest in earnings of consolidated subsidiaries, joint ventures and partnerships
41. **Net income, core** = reported net income, adjusted to remove the impact of unusual items
42. **Net income, reported** = reported net income
43. **Operating lease interest expense** = operating lease expense ÷ 3
44. **Operating lease non-interest expense** = operating lease expense * 2/3
45. **Operating lease expense (rent)** = next period operating lease expense
46. **Operating lease, capitalized** = operating lease expense * 6
47. **Receivables** = reported receivables + notes receivable
48. **Revenue (and sales, interchangeable)** = reported revenue of owned operations

1. All numbers are to be annualized and normalized where applicable.
2. All ratios include the assets and income of any minority interests. Minority interests are included in total capital. When minority interests are removed from total capital and net income the numbers and ratios must be properly annotated.
3. Debt can also include off-balance sheet financing (see Off-Balance Sheet Items section on page 10 for further information). Ratios including this debt number would be separate and annotated.
III. Ratio Term Definitions\textsuperscript{1,2}

49. **Revenue, system** = revenue + franchisee and affiliate revenue
50. **SG&A** = selling, general and administrative expenses
51. **Tax, cash** = actual cash remitted
52. **Tax, deferred** = reported deferred income taxes, may be adjusted to remove the impact of unusual items
53. **Tax, income** = cash and deferred income tax, adjusted to remove the impact of unusual items
54. **Tax, reported** = reported income tax, before removing the impact of unusual items
55. **Unusual items** = merger & restructuring charges + impairment of goodwill + gain (loss) on sale of assets & investments + asset writedown + insurance & legal settlements
56. **Working capital** = current assets - current liabilities

1. All numbers are to be annualized and normalized where applicable.
2. All ratios include the assets and income of any minority interests. Minority interests are included in total capital. When minority interests are removend from total capital and net income the numbers and ratios must be properly annotated.
3. Debt can also include off-balance sheet financing (see Off-Balance Sheet Items section on page 10 for further information). Ratios including this debt number would be separate and annotated.

ACCOUNTING TREATMENTS AND ADJUSTMENTS

DBRS adjusts financial information to provide greater analytical transparency, rather than recast financial statements per se. The adjustments can be universal (see below) or be industry-specific (see the respective DBRS methodology). In many cases, DBRS will make adjustments only when the impact is considered material and some adjustments will be isolated to certain key ratios.

Asset values reported under Canadian or U.S generally accepted accounting principles (GAAP) are normally based on book values. Asset values reported under International Financial Reporting Standards (IFRS) may be based on book or market values. DBRS may show ratios both ways for a period of time (i.e., using market values and book values).

(Note: When a company issues restated financial statements, DBRS will use them for the last two fiscal years and any current stub periods. The years prior will remain as shown in the annual report for that year.)

INCOME STATEMENT

1. Revenue
In most cases, companies report gross revenue. In some cases, companies provide net revenue after certain expenses. In almost all cases, DBRS will use gross revenue, unless net revenue conforms to industry practice.

In some cases, companies sell to their franchisee, dealer and/or affiliate networks. In these cases, companies often provide system revenues that provide total network sales to end customers. Provided they are clearly marked, DBRS can include system revenues and related ratios along with reported revenue.

2. Operating Earnings
In most cases, operating earnings (gross income, EBITDA, EBIT, etc.) are prior to the deduction of interest expense and income taxes. Gross income is revenue less cost of goods sold. EBITDA is gross income less SG&A. EBIT is EBITDA less depreciation and amortization. Earnings should not include unusual items. (See Unusual Items section on page 6 for further discussion of this).

3. Interest Expense (Gross)
DBRS includes only cash interest attributed to indebtedness in interest expense. This includes capitalized interest. Any other expense/income items are removed. DBRS adds the cost associated with a hybrid security to fixed-charge coverage ratios.
4. Fixed-Charge Expense
DBRS adds additional items to interest expense to drive the fixed-charge expense. This includes preferred share dividends (tax adjusted, i.e., divide by 1 - tax rate).

5. Capitalized Development Costs
DBRS does not normally adjust reported financial statements by shifting capitalized amounts to expense, although such adjustments will be made in calculating certain financial ratios. In cases where capitalized development costs are material, the higher earnings should be annotated so that they are seen in the proper context.

6. Unusual Items
A wide variety of metrics can be distorted by items that may not meet the accounting definition of “extraordinary,” but are nevertheless one time and considered unrepeatable. Unless these unusual items are identified and removed, with proper tax adjustments, earnings and cash flow metrics and related ratios cannot be considered as “core.” Having noted this, care must be taken in any of the following adjustments:

(a) There are cases where it would be incorrect to remove items in isolation (there may be corresponding related expenses or revenues).

(b) There are cases where certain costs may be ongoing and the one-time conclusion must be challenged (year-after-year reorganization costs is one example).

(c) Unusual items should not be confused with volatile items. An entity may have a very unstable revenue source but it is still part of its ongoing operations and should not be removed from core earnings simply because it is volatile.

(d) Companies can default due to one-time costs. It may be reasonable to remove an entity’s major litigation settlement or reorganization costs to get a more accurate picture of core results, but one should not forget that whether it is a one-time cost or otherwise, these expenses are still a cost that could cause a variety of challenges. The latter may include covenant triggers.

7. Pre-Tax Income
As noted above, DBRS may normalize pre-tax income by removing extraordinary, unusual and any other one-time items that are not expected to reoccur in the future.

8. Income Taxes
Where possible, DBRS may adjust accounting income taxes to remove the impact of one-time items, etc.

9. Net Income
Core net income is derived using the normalized pre-tax income and normalized income tax as noted above (versus reported net income). Core net income is intended to approximate net income had there had been no one-time items. (See Cash Flow Statement Adjustments section on page 7.)
CASH FLOW STATEMENT ADJUSTMENTS

1. Cash Flow from Operations
Cash flow from operations starts with core net income, adds back normalized deferred taxes (if a reasonable estimate can be made). As well, the other non-cash items that normally flow-through the income statement are reversed (i.e., depreciation). This yields a normalized cash flow from operations, which is intended to approximate what cash flow would have been absent any one-time items and therefore permits valid year-over-year comparisons.

2. Free Cash Flow
Free cash flow is defined as cash flow from operations less (a) capex, (b) dividends and (c) change in non-cash working capital. It should also be net of payments on pension deficits and any residual cash credits/debits that were excluded when deriving normalized cash flow from operations. In this way, the final change in cash will reconcile with the change in cash noted in the company’s statement once the investing and financing activities are taken into account.

BALANCE SHEET ADJUSTMENTS
Balance sheet ratios that use market values or exclude intangible assets (such as goodwill), for example, can be substantially different than those that use book values or those that include intangible assets. Cash flow statements are not generally affected by these accounting factors to the same degree and may, therefore, be more meaningful. Nonetheless, balance sheet analysis is important in assessing credit risk and what follows is relevant to this.

1. Asset Valuation (General)
   (a) When two or more companies in the same industry elect to have different approaches under IFRS so that similar assets that do not have materially different values (i.e., book versus market), the values and ratios are not adjusted. However, where the differences are noteworthy, the analysis should address this and the credit implications, if any.
   (b) Companies making acquisitions or investing in brands can have large amounts of goodwill and intangible assets. Similarly, long-term assets in general may be overvalued or undervalued simply through obsolescence, depreciation or amortization over too long a time period or overestimates of residual values. In these cases, the equity base can be inflated, yielding more favourable debt-to-equity and debt-to-capital ratios. Conversely, the company could show a lower return on equity (ROE). This will need to be taken into account where there are credit implications.

2. Surplus Cash and Marketable Securities
DBRS normally focuses on gross debt ratios, although net debt ratios are often determined. DBRS does not generally net cash from debt levels because it is not easy to establish that the cash will be used to reduce debt in the future. One must understand the company’s working capital needs, the nature of its short-term funding requirements, whether the use of the funds is restricted by where they sit in the company’s structure (different country or regulators could be issues) and future plans regarding capital expenditures, expansions and acquisitions. DBRS tends to treat these situations on a case-by-case basis and would require a high degree of comfort before focusing on net debt ratios.

3. Receivable and Inventory Valuation
Receivable and inventory valuations are not adjusted to reflect last in, first out/first in, first out accounting differences.

Meaningful changes in turnover ratios or meaningful differences in ratios with comparable companies should be investigated to determine if it is based on accounting differences.
4. Equity Investments
Under many accounting standards, the equity accounting method is used where the company has an ownership interest of between 20% and 50%. When sizeable, this can have a distorting impact on several important ratios. In the case of interest coverage, the equity accounted earnings will appear under equity income and will thus not be part of EBITDA coverage ratios. Cash flow ratios can be impacted because only dividends from equity investments are included in cash flow.

As a base policy, DBRS believes that equity investments should be conservatively funded. In some cases, it is not unreasonable that some debt funding be used, but 100% equity funding is a more conservative stance. Balance sheet ratios can be distorted if the equity investment is debt funded. If the company or underlying investment is highly leveraged, there is some degree of double leverage.

In assessing the credit implications of the foregoing, the following factors may need to be considered:
(a) What is the risk profile of the equity investment? How stable are future earnings and dividends?
(b) How core is this investment to the company? Would the company invest more funds if needed?
(c) What is the balance sheet strength of the investment on its own, including debt, cash flow and goodwill considerations?
(d) How marketable is the investment and what is a reasonable sale value? The value of control may be a factor to consider here, as is the future prospects of the entity.
(e) Who owns the other portion of the equity investment and what implications could this have?
(f) How different is the earnings stream coming to the company versus the dividend?
(g) Other than the equity investment itself, are there any other ties between the company and the equity entity, such as debt holdings, loans, joint ventures or other business relationships?
(h) What other relevant factors are unique to the situation, industry or relationship? In general, equity investments that are considered to have a weak credit profile should be treated as being fully equity funded.

5. Goodwill/Intangibles
Large goodwill/intangible valuations should be reviewed periodically, especially where a material impairment could cause insolvency and breach a covenant. The company should advise on any recent valuations performed.

6. Liability Valuation (General)
When two or more companies in the same industry elect to have different approaches under IFRS so that similar liabilities have materially different values (i.e., book versus market), the values and ratios are not adjusted, unless there is publicly available information. The differences are often minor, but where they are material the report needs to address the reasons.

7. Hybrid Securities
DBRS has a methodology to deal with assessing the equity weighting for hybrid instruments. For more information, see DBRS Criteria: Preferred Share and Hybrid Criteria for Corporate Issuers (Excluding Financial Institutions). In general, the debt portion of the hybrid security is added to debt and the entire amount is added to equity. With a debt hybrid, all the interest expense is added to other interest expense when calculating (i.e., interest coverage ratios). With an equity hybrid, the entire dividend is added to other dividends when calculating (i.e., fixed-charge coverage ratios).

8. Deferred Liabilities
In most cases, DBRS does not include deferred liabilities in the analysis of the capital structure.
9. Minority Interest (MI)
DBRS does not include MI with common equity or total equity. Hence, with the ROE ratio, total earnings as used in the numerator would exclude the portion attributable to the MI in order to be consistent with the denominator, which also excludes MI.

Conversely, MI is included with total capital. Hence, with the return-on-capital ratio, total earnings as used in the numerator would include the portion attributable to the MI in order to be consistent with the denominator, which also includes MI. Also with the total debt-to-capital ratio, as total debt would include the subsidiaries’ debt, total capital would include that part of the subsidiaries’ equity owned by others (the MI).

10. Shareholder Equity Valuation
As noted above, values reported under IFRS in some cases will include market values. In the first year under IFRS, any changes to market from book values would be included in equity. These changes can be material. Thereafter, only periodic changes in market values are included (i.e., quarterly or annually). DBRS may elect to show capitalization ratios with and without the changes associated with market values.

11. Accumulated Other Comprehensive Income (OCI)
In analyzing debt leverage and ROE ratios, it may be necessary to view equity without the accumulated OCI/(loss) account. In addition to unrealized derivative gains or losses, the accumulated OCI account will typically consist of the following items:
(a) Accumulated foreign exchange translation adjustments.
(b) Minimum pension liability adjustment.
(c) Net unrealized gains on securities.
(d) Net unrealized gains/(losses) on derivatives.

In the case of derivatives, gains or losses on cash flow and foreign exchange hedges are initially recorded in OCI and then transferred to income when the hedged asset, liability or anticipated future transaction affects earnings. By excluding these various items from equity, the equity could be understated or overstated (depending on the direction of accumulated OCI).

12. Consolidation
Accounting standards sometimes dictate consolidation even though deconsolidation would provide a clearer and more accurate view of key ratios. One example is corporations that have one or more leveraged subsidiaries with a holding company at the top. If the holding company is to be rated, DBRS will generally assess the holding company’s deconsolidated financials.

Another example is manufacturing entities that have wholly owned finance companies. Deconsolidating the captive finance operation allows DBRS to view the manufacturing entity’s ratios without the finance debt, while the finance side can be properly assessed as its own entity that can operate with a much higher level of debt.

Alternatively, sometimes entities are separate and deconsolidated, but economically, should really be treated as one operation and consolidation will provide this better view. An example here would be the case of a wholly owned subsidiary that, although legally separate, is integral to the owner and, therefore, one would expect that the subsidiary and its debt would be highly supported by the parent company.

13. Variable Interest Entities
Consolidation guidance for variable interest entities can vary depending on the interpretation by the relevant accounting guidelines. Consolidation is based primarily on implied control. The rules are intended to provide a more complete picture of the risks and obligations of the consolidated enterprise, and help assess the amounts, timing and uncertainty of cash flows. DBRS may make adjustments where it improves the comparative analysis.
14. Pension Plans
Companies with defined benefit pension plans face risks related to investment performance and the ability to fully provide for the future obligations that are the company’s responsibility. Defined contribution plans are not usually of concern because the employees take the investment risk and the current funding basis prevents the underfunded situations that can develop with defined benefit plans.

When analyzing defined benefit plans, the following items are taken into consideration to assess the unfunded liability.
(a) How large is it in relation to the size of the company? Specifically, would the extra cash needed to reduce the liability cause a strain on cash flow or leverage?
(b) How conservative are the key investment, interest rate and wage assumptions?
(c) How much timing flexibility does the company have in returning the plan to fully funded status?
(d) Are there legislative or regulatory issues to take into consideration, in addition to the accounting guidelines? Are major changes expected in the future?

OFF-BALANCE SHEET ITEMS
In addition to the aforementioned discussion on adjusting a company’s financial statements, there are a variety of ways that traditional debt-related ratios can be distorted by obligations that are not included in the base financial statements. The following represents a checklist of items that DBRS would adjust for (if significant), along with a general description of how the adjustment should be made.

1. Operating Leases
DBRS normally deals with operating leases by estimating the impact they would have on debt and interest costs if they were accounted for on the balance sheet. The method for adjusting debt ratios is to take the operating lease payment for the next one-year period, multiply it by six and add it to debt (and thus it is also added to total capital). For coverage ratios, the lease payment is added to gross operating profit and divided by three and added to interest.

Where possible, the present value of the operating leases can be used in lieu of the estimate described in the paragraph above. The present value is calculated using the minimum operating lease obligations, as recorded in the notes to the financial statements or provided by the issuer.

The capitalized amount of operating leases is normally added to on-balance sheet debt when the amounts are material and represent financing for assets that are a core part of operations.

2. Guarantees
Generally, if an issuer has guaranteed debt of a separate entity (which debt has not been consolidated), the guaranteed debt should be added to the issuer’s on-balance sheet debt for the purpose of calculating the issuer’s debt-related ratios. If the separate entity has more than adequate cash flow to service the guaranteed debt, however, DBRS may take this into account in evaluating debt-related ratios of the issuer.

3. Contingent Liabilities
Contingent liabilities can be similar to guaranteed debt. However, by their nature, there is a much wider horizon of potential situations. In most cases, a contingent liability is not as meaningful as guaranteed debt because there are circumstances whereby the company may be able to avoid the liability in question. There may also be other options for the company that reduce or avoid the impact of the liability. DBRS assesses contingent liability on a case-by-case basis, considering the likelihood of any impact, as well as the magnitude of the impact.
4. **Non-Recourse Debt**

Non-recourse debt is usually debt at a subsidiary level whose lenders have no recourse to the parent in the event of default. The treatment depends to some degree on the following:

(a) The ability of the subsidiary to cover debt payments on its own; the higher the ability of the subsidiary to cover debt payments, the less it is a concern for the parent.

(b) The level of equity that the parent has invested in the subsidiary. Smaller investments may mean that the parent could more easily abandon the subsidiary.

(c) The importance of the subsidiary to the parent. If the subsidiary is of critical importance to the operations or the long-term strategy of the parent, the latter may have to correct any problems with new capital.

(d) Other situations with government, regulators or investors could limit the parent from easily walking away from a weak investment. For any of the aforementioned reasons, a parent may be pressured to support the debt of a subsidiary, even if the latter is not consolidated on its financial statements. In these cases, the debt may be added back to the balance sheet of the parent for the purpose of adjusted ratios.

5. **Litigation**

For most companies, it is not unusual to have litigation events highlighted in the notes to the financial statements. It is by its nature a highly subjective area to assess and one segment where interaction with a company’s senior management often may not add significant new information due to the company’s desire to have comments restricted by their legal departments. Normally these risks are not factored into the issuer’s risk profile, unless the litigation has resulted in a likely settlement that is quantifiable.

6. **Purchase Contracts**

Purchase contracts on the supply side are normally used to reduce volatility by locking in either supply availability or price over some extended time period. On the sales side, purchase contracts commit the company to sell a certain level of product at a given price over some extended time period.

In most cases, supply purchase contracts are positive from a credit quality perspective, as they reduce volatility and increase certainty of supply. However, they can be negative if the company operates in a very competitive industry and the expectations of supply pricing go against expectations, or if committed volumes are in excess of actual requirements. In these cases, the company may not be able to pass on expected pricing to its buyers, as peers are able to offer lower costs. Even if this does not occur, the company could experience lower earnings than its peers, leaving it at a potential competitive disadvantage in terms of financial flexibility and cash flow levels to reinvest in its business.

On the sales side, there are similar disadvantages if prices and supply accessibility move against the company’s rationale for setting up the contract.

In assessing purchase contracts, the potential benefits and risks are weighed using some form of stress analysis to determine what set of industry changes would cause significant problems for the company.

7. **Securitizations**

Securitized assets of non-financial companies are normally added back to debt to calculate adjusted debt ratios. There are rare situations where it may be appropriate to add back less than the total securitized assets. Key factors that must be met here would include situations where the seller has sold part or all of the recourse, and where DBRS is comfortable with the risk of moral recourse action. (Note: In most cases IFRS requires securitized assets to be added back.)
8. Zero Coupon Debt
The use of zero coupon debt by an issuer can cause an illusionary improvement in normal coverage ratios. Normal accounting will cause a debt liability to rise to the final redemption price over its expected life and will add the adjustment to interest costs, thus maintaining a true interest coverage. However, because the interest cost was not paid, it will not be deducted from cash flow and, as such, cash flow coverage will be overstated.

9. Derivatives
The derivatives and hedges used by a company should be reviewed where material. DBRS is generally uncomfortable with companies that use derivatives as a profit centre (i.e., speculative/trading derivatives). Where derivatives are used for matching or hedging, a key factor to consider relates to the risk of counterparty.

In addition, certain derivative instruments are measured at fair market value (FMV) on the balance sheet, with the non-cash changes in FMV recognized in earnings in the Income Statement or Accumulated OCI in shareholders’ equity. Where these FMV adjustments are material, DBRS may remove the periodic adjustments to allow the ratios to reflect the underlying trends.