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Position Paper: The role of Financial Statements in the rating process

In assigning Credit Ratings, an "opinion regarding the creditworthiness of an entity"[1], Credit Rating Agencies ("CRA") are required to comply with the numerous requirements of the EU Regulation on CRAs in order to ensure the quality and independence of the assessment. With respect to the rating process, Article 8 (2) of the CRA Regulation states the following: "A credit rating agency shall adopt (…) all necessary measures so that the information it uses in assigning credit ratings (…) is of sufficient quality and from reliable sources". A central element of the information package requested by Credit Rating Agencies relates to the financial statements of the issuer.

Audited Financial Statements as reliable source for CRAs

Financial statements are prepared by auditors, whose independent role "is to certify the company's financial statements, i.e. to provide stakeholders such as investors and shareholders with an opinion on the accuracy of the company's accounts"[2].

The EU Directive 2014/56/EU amending Directive 2006/43/EC on "statutory audits of annual accounts and consolidated accounts" includes numerous requirements for auditors to ensure the independence and objectivity of auditors. Audit activities can only be carried out by approved auditors, the registration requiring an examination of theoretical knowledge (including on financial analysis, risk management and internal controls) and on education. Auditors are subject to on-going supervision and their recognition may be withdrawn for failing to meet the requirements.

Based on these stringent requirements on auditors, CRAs consider that audited annual consolidated financial statements stem from a reliable source with sufficient quality. This approach is consistent with Recital 35 of the CRA-Regulation:

"In order to ensure the quality of credit ratings, (…) a CRA should be able to envisage, inter alia, reliance on independently audited financial statements"

We would like to highlight some important additional aspects regarding financial statements, as a central element during the credit rating process:

- Going concern principle: this principle implies that the issuer will continue to exist for a longer period and affects a.o. the valuation of assets (these may be substantial different in case of immediate need to monetize the asset due to an insolvency or bankruptcy). According to Article 28 (2) (f), auditors should provide a "statement on the material uncertainty relating to events and conditions that may cast significant doubt about the entity's ability to continue as a going concern".

[1] according to Article 3 (1) (a) of the Regulation (EC) N° 1060/2009 of the European Parliament and the Council of 16 September 2009 on credit Rating Agencies. (in this paper referred to the "EU Regulation on CRAs")
[2] see European Commission Memo on "Reform of the EU Statutory Audit Market" dated June 16th, 2014 available at: http://europa.eu/rapid/press-release_MEMO-14-427_en.htm?locale=en

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- According to Article 28 /2((c) of the Audit Directive, the auditor may issue “unqualified”, “qualified” or an “adverse” opinion whether the “annual financial statements give a true and fair view”. In case the auditors does not issue an “unqualified” opinion, the CRA will enquire on the stated topic and may refrain from issuing a rating if deemed that not sufficient information is available (according to Annex I Section D, I (4) of the CRA Regulation).

In order to assess the historic performance of an issuer, CRAs usually require 3 to 5 years of financial statements.

The analysis of a CRA goes beyond the financial statements

- Depending on the type of industry and the seasonality of accounts, annual or year end financial statements may not be fully representative of the underlying risks of the rated entity. In order to complement the analysis based on annual financial statements, CRAs may therefore request quarterly accounts or take into account management figures (the later considered “confidential information” if not disclosed by the company).
- Since Credit ratings are forward looking opinions on credit risk, CRAs may require financial forecasts from the issuer (preferably approved by the board and disclosed to the market) with an acceptable time horizon, to complement the view and the implementation of the strategy that supports the forecasts. Such forecasts should be supported by underlying assumptions and prepared, ideally, in a financial model allowing for sensitivity and stress test scenarios.
- CRAs generally calculate financial ratios according to their own guidelines. These adjustments are based on each CRAs restatement criteria of financial statements in order to ensure consistency across industries and different accounting principles (IFRS, local GAAPs etc.)
- Credit ratings also include in their methodology indicators based on qualitative factors (e.g. strategy, corporate governance, etc.)”. Additionally, CRAs may hold meeting with the management (independent whether the issuer requested the rating itself).
- In case of issue ratings, the CRA will request the documentation in order to analyze the ranking of the specific instrument within the liabilities structure of the rated entity.

The above points are a highly limited list of items taken into account by CRAs.

Civil Liability aspects

The 2013 amendment of the CRA Regulation[3] introduced a Civil Liability Regime on CRAs (Article 35a) which states that the basic information provided by an issuer within the rating process <u>must not</u> be misleading or inaccurate.

[3] Regulation (EU) N° 462/2013 of the European Parliament and of the Council of 21 May 2013

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During the audit process, auditors usually require from the management to provide a written representation that it has provided all relevant information and that all transactions have been recorded and are reflected in the financial statements.

Since audited financial statements are most frequently provided by the issuer to the CRA and that Recital 35 of the CRA Regulation supports reliance on audited financial statements produced by independent auditors, CRAs can't be held liable for inaccurate or misleading financial statements and the consequences during the rating process resulting thereof.

About EACRA Members registered with the European Securities and Markets Authority ("ESMA") as Credit Rating Agencies

A.M. Best Europe - Rating services Limited (AMBERS) is a subsidiary of A.M. Best Inc who have been providing ratings to the Insurance Sector since 1899. AMBERS' rating coverage includes regional, national and global insurers located throughout Europe, the Middle East and Africa.
ARC Ratings is an international rating agency with a presence in 11 countries on four continents. ARC is registered with ESMA and results from a partnership of 5 leading rating agencies operating in India, Brazil, Sub-Saharan Africa, Malaysia and Europe. This partnership has over 6000 rating clients and 400 ratings staff, giving ARC global coverage as well as vital local knowledge

Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies

Axesor: The first Spanish Rating agency registered with ESMA. Specialized in the middle market segment, with ample coverage of the Spanish corporate market.
Capital Intelligence (CI) offers independent rating opinions on financial institutions, corporates and governments in a wide range of countries, especially the emerging markets of Asia, Europe and the Middle East.

Cerved Rating Agency: Italian Credit Rating Agency recognized ECAI by Bank of Italy

Creditreform Rating: based in Germany, a company of the Creditreform Group that is European market leader in the sector of business information was founded 2000 and is specialised in ratings of companies, bonds, funds and structured finance products across Europe.
CRIF: International Credit Rating Agency based in Italy providing both solicited and unsolicited Corporate ratings.
Dagong Europe Credit Rating, headquartered in Milan, was registered by ESMA in June 2013. It is owned by Dagong Global Credit Rating and led by Ulrich Bierbaum as General Manager. Dagong Europe provides European and Asian investors with credit opinions on financial institutions (including insurance companies) and non-financial corporate.
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