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Panel discussion on principles, objectives and expectations of an audit

Ratings are not an audit

but an assessment of credit risk

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3 partners in the same boat

Rating agencies, auditors and regulators share a common duty which is to protect investors

- **Auditors:** assessing probability of default is a legal duty because financial accounts are based on an «ongoing concern» for the business
- **Rating agencies:** historically, their value has been to improve transparency in the credit markets
- **Regulators:** ratings are a criteria to assess the solvency of banks

The subprime crisis

- **What is an AAA?** the rating scale is neither consistent between corporates, municipal bonds and structured finance, nor between rating agencies (rating is a probability of default for S&P and an expected loss for Moody's).
  - Rating agencies have been considered as negligent in their review on possible downgrades for the subprime
- **How to avoid a major financial crisis?** If spreads are no longer driven by «formal» ratings but by «market implied ratings», volatility in the financial markets could significantly increase. Loss of confidence in rating agencies is bad news for the markets and more specifically for the banking system which is very vulnerable to rumors
  - Thanks to securitization, the US problem has turned into a worldwide mess; who is responsible?

Rating is an independent opinion on credit risk

What the rating agencies say : their responsibility is the same as a financial analyst's, but not as an auditor's

- **There is no due diligence in the rating process** but a stronger ability than in equity research to look at the economic reality behind the figures

  1. Liquidity management: rating agencies analyse a «stressed» statement of cash flow for the next 6 months
  2. «Notching»: impact on severity of loss of legal or structural subordination

- **Credit metrics are adjusted but most of the adjustments are based on certified figures. Enron, World Com, Parmalat, the subprime crisis: fraud is THE major risk for rating agencies**

Scoring: garbage in, garbage out

- Ebidta and financial debt are not «normalised» under US and IFRS GAAP: Moody's and S&P are trying to assess if accounting choices are «neutral» for financial metrics;
- Equity is not an issue for rating agencies (the focus is more on cash flow statement than on balance sheet) but FFO (flow from operation i.e. cash flow) must be adjusted for «exceptional items».
- There is no consistency in the adjustments because key information is missing (such as replacement value for operating leasing, cash outflows for pension liabilities, split between growth and maintenance CAPEX, between «restricted» cash and cash in hands, etc)

There are 1/2 auditors for a company: does it create value to get more than 2/3 rating agencies ?

- Rating is a «natural» oligopoly if credit opinion have to be based not only on public information, but also on «management evaluation»
- Too much competition between rating agencies can weaken their business model because they are listed companies and must be profitable if they want to remain independent
  - «rating shopping» is probably not in the best interest of investors