

# If Credit Rating Agencies Provide Inaccurate Analysis of Sovereign Nations, How can Business Schools Effectively Teach Financial Statement Reporting?

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## Abstract

The premier credit rating agencies, most notably, Standard and Poor's (S P), Moody's and Fitch, have embarked on an unsolicited ratings downgrade of the European continent. Recently, Greece, Portugal and Ireland have been assigned an unprecedented 'junk status' ratings beginning in 2010. (Alessi, Wolverson, Sergie, 2013). In 2012, SP continued with the downgrade, including such premier euro zone members as France and Austria in their financial analysis aimed at redeeming their credibility issues caused by the 2007 financial debacle. The 'Big Three' credit rating agencies have been accused of inflating ratings on questionable debt securities that ultimately led to the subprime prime mortgage crisis. The question being asked by many in the international community, is whether the 'Big Three' are being too conservative in their ratings of sovereign nations by ignoring cultural value in an attempt to correct their past mistakes? Can we teach business students effectively if the ratings process is viewed as a failure?

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**Index terms**— cultural illiteracy, effective teaching.

## 1 Introduction

The purpose of rating a sovereign nation is to provide the international investment community with information regarding the risk associated with that country's debt. The resulting impact of either a positive or negative rating, characterized by a letter grade, has a tremendous bearing on the ability of that sovereign nation to have access to debt in the future. Recently S&P, Moody's and Fitch, or the "Big Three", have embarked on a campaign to provide unsolicited ratings of the euro zone participants much to the dismay of the countries. Some in the international arena have named the credit rating agencies actions as punishing the European continent and calling the process Europe's new plague (AP, 2012). By the time the "Big Three" were done, nine countries in the euro zone had their credit ratings lowered. Only Germany survived the carnage and retained the coveted "triple-A rating". As a result of the credit ratings moves, more than half of the countries using the euro had their ratings slashed by the unforgiving ratings knife (Alessi, Wolverson, Sergie, 2013). Previously highly rated sovereign nations, including France, Italy, Austria and Spain were all subjected to the downgrade (Schuman, 2012). This downgrading spree was preceded by a similar process in the United States earlier in 2011.

The European countries have continuously blamed the credit rating agencies for causing the debt crisis that roared through Greece, Ireland and Portugal recently. Unfortunately, the euro zone is not only united in currency but also in each other's problems. The downgrading of many of the key participants in the euro zone points to the inherent weakness an integrated economic collaboration causes on the stronger participants. Not only are the countries whose ratings have been downgraded impacted by the "Big Three" but all members of the euro zone feel the resulting aftershock. When diverse countries unite through their monetary policies, the resulting chain

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formed by this association is sadly only as strong as the weakest links. Therefore, the problems of the weakest euro zone partners become the problems of the healthier euro zone players.

## 2 II.

### 3 The Ratings Process

The ratings process involves an assessment of the future growth, revenue stream, disbursements, debt and the subsequent risk associated with all of these measures. One of the largest stumbling blocks in the process is the requirement that the ratings agencies essentially "guess" what they believe the future will bring. The use of benchmarks, prior history and economic forecasts all play a major role in the process. In addition, the current value or net worth of the entity is integrated into the process in order to make an assessment of the future viability of the entity under the ratings microscope. The entities future values or assets are measured against comparable entities to determine their position in the market. In addition, the future debts or liabilities are also examined to determine the degree of leverage or risk associated with the future payable outflow. Eventually, all of these numbers must be analyzed to enable the credit ratings agency to form a prediction about the risk or safety of the entity under investigation.

The ratings process for a corporation and a sovereign nation take similar concepts into account when making a rating determination. But, can a ratings agency be as effective in rating a sovereign nation as they can when rating a single corporate entity. The sheer size of a sovereign nation compared to the single corporate entity complicates the process ten-fold. The similarities are obvious: both corporate entities and sovereign nations have revenue streams and cash disbursement requirements. So, essentially, the income statement, for both rating subjects, has marked similarities. True, the sources of revenue are disparate, tax revenue as compared to sales or service revenue, but both provide sources of income to the entity. The same is true for the disbursement side of the analysis, different uses with a similar outcome. Therefore, the ratings agencies can reasonably review the prior income and disbursement stream and make fairly reliable predications about the future.

The differences become more apparent when one examines the valuation process of a sovereign nation compared to a corporate entity. The debt side of the valuation process is fairly obvious, as debt has no future valuation uncertainties as a component in the valuation process. The only uncertainty pertaining to debt is associated with the ability of the borrower to repay the debt along with the interest rate variable. It is the future value or the asset side of the valuation process that provides the biggest challenge to a financial analyst. An analyst merely needs to examine the balance sheet of any corporate entity to discover the future value of that company. The assets include both tangible and intangible future values. Some of these assets are valued at fair market and others at historical cost. In essence the analyst compares the corporate assets to liabilities and is able to ascertain net worth. But, does such a process take place when valuing a sovereign nation? III.

### 4 Does the Ratings Process Include all Value?

When the financial analyst determines the credit rating for a sovereign nation or corporate entity, the goal is to include all the historical data together with future forecasts. Clearly, the historical data is more reliable and the future valuation component problematic at best. For sovereign nations, the future value component is driven by estimates of GDP growth together with an analysis of fiscal policy. A similar process is undertaken with a corporate entity and both processes include an overall analysis of the general global economy. Regardless of how in-depth a future guesstimate might be, the process is flawed by the uncertainty of the global economy. Therefore, when providing a sound basis for the valuation process, the financial analyst must rely more heavily on the historical component of the process, in essence the income statement for sovereign nations because their balance sheet is lopsided. What assets are included on a sovereign nation's balance sheet? Is the future value of a sovereign nation properly valued if it lacks many intangible assets that are included on the corporate entity's balance sheet?

An examination of a typical corporate balance sheet will include such vague assets as Goodwill, which represents the future benefit the entity will receive from an acquisition. The future earnings potential are, therefore, included in the valuation process of corporations. Unfortunately, a similar process does not take place for sovereign nations. Their balance sheets contain all the debt or negative value but little future assets or positive value. Perhaps, the financial analysts and rating agencies need to revisit the way in which they value sovereign entities.

#### IV. Is the Valuation Process Culturally Illiterate?

In response to Standard & Poor's credit downgrade of their country, Italy claimed the ratings process failed to include their cultural wealth in the analysis. Italy's auditor general decried S & P's overreliance on budget deficits and lack of attention to cultural value (Rankin, 2014). The future value of the plethora of historic treasures infused throughout Italy's country is nowhere to be seen in the ratings valuation process. If corporations are allowed to include the future value of goodwill in their credit ratings process, why is a sovereign nation not afforded the same process? Perhaps, art, museums, churches, monuments and a rich cultural history are, in essence, the goodwill of a sovereign nation? According to Italy's auditor general, the Corte dei Conti, the unsolicited credit analysis and resultant downgrading of the credit rating of the country is flawed at best and, perhaps, illegal at worst (Rankin, 2014). In addition, the auditor general stated that the underpinning of Italy's future economic

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strength is driven by the historical significance of the art, culture and landscape, which was ignored by the credit rating agency ??Levine, 2012).

Italy's auditor general believes that S & P's "best guess" as to their country's creditworthiness was inaccurate due to the fact that the rater failed to include the country's participation in the process. The credit agency merely availed themselves of the public information available and in essentially "slapped" a rating on the country according to the auditor general ??Levine, 2012). The ratings agency rarely provides unsolicited ratings to sovereign nations. The process is usually undertaken at the request of the country being rated and includes a ratings agreement. Therefore, the unsolicited and unpaid rating provided Italy in 2012 by S & P, which resulted in a downgrade of the country's creditworthiness to BBB+, was problematic from the inception (Rankin, 2014). How valid can a ratings assessment be without the involvement of the entity being rated? Perhaps, that is why S & P failed to include Italy's rich cultural value in the ratings process. The absence of the value of Italy's culture and art in the valuation process has been labeled "cultural illiteracy" on the part of the ratings agency by the Italian government.

In 2012, when the credit rating agencies downgraded the creditworthiness of the United States, the official response of the US Treasury Secretary focused on the "stunning lack of knowledge about basic US fiscal maths" (Rankin, 2014). Perhaps, the Corte dei Conti is making a similar assertion regarding the credit rating agencies' stunning lack of Italy's cultural value.

V.

## 5 The Ratings Conundrum

The intrinsic value of a sovereign nation's cultural history, art, museums and landscape are assets that must be included in the ratings process in a similar way intangible assets are included in the valuation process for corporations. S & P stated the reason for the downgrade of Italy was based in part upon an estimated increase in problematic assets as viewed by the raters. But the raters failed to include the cultural assets that are at the core of the future viability of the country, and as such, erred in the ratings conclusion. If S & P based much of their analysis on the possibility of future deterioration of the collateral value of some of Italy's assets, clearly asset values are an essential part of the valuation process. The failure to include the future value of a sovereign nation's cultural assets indicates the problems with the valuation process and the subsequent rating.

Italy has a tremendous amount of debt, and, they are one of the largest euro zone debtors. Debt appears to be more risky when a nation lacks the assets to provide the balance. The failure of the ratings agency to include the cultural assets of Italy under reports value and over reports risk. In order to ascertain the future viability of any entity whether it be corporate based or a sovereign nation, the ratings process must include all the value. Sovereign nations' balance sheets are replete with debt but lack the asset value needed to provide the balance to the net worth equation. Italy, like many of its euro zone neighbors, has a cultural value that must be included in the asset section of the country's balance sheet for the value to be accurate. Italy is a valuable country because of the historical significance of its past and, to disregard the value of the cultural assets is a travesty to the nation.

## 6 VI.

## 7 How to Effectively Teach Financial Statement Reporting

The problem faced by academics attempting to infuse real-life business examples into the learning process includes the disparate business practices as described above. If the "professional" financial analysts have problems determining what are the acceptable assets to include when valuing a company or even a nation, how can a student comprehend the process? Unfortunately, so much of the practical application of business valuation practices has been proven, in hindsight, to be wrong. The plethora of financial reporting restatements, audit failures and now the credit rating kerfuffle has undermined the ability of academics to infuse practice into the theoretical component of business classes.

The financial reporting community is faced with an overwhelming task of trying to integrate the international reporting standards with the US GAAP guidelines while attempting to navigate an ever evolving business environment. The lack of consistency and agreement in the guiding principles embraced by the international business community further complicates both the financial reporting process and the educational component. The failure of the international business community to determine what rules are appropriate for reporting the financial results of large multinational entities only serves to weaken the business education being taught on college campuses around the world. The business community needs to provide the guiding principles that are deemed effective for international reporting purposes so that the academic institutions can more effectively educate the current business students with accurate educational tools. The inaccuracies of the current financial analysis reporting system is not only undermining the credibility of the ratings agencies but is weakening the value of a business degree.

The business curriculum developed by the international business programs has provided an excellent foundation for students and business leaders to apply accounting and valuation theory in a practical application for valuation purposes. Why does the professional credit and business analyst fail to apply the basic components of valuation theory taught in the classroom to the real-world valuation process? Someone is failing?..is it the credit rating agencies or are the theories widely accepted and taught in academia not practical in a real-world valuation

process? This discussion needs to take place before the entire valuation process is completely categorized as a failure.

## 8 Global

## 9 Conclusion

Italy is a rich nation and the impact of the downgrade on their economy was senseless. Most sovereign nations have problems and risks that need to be included when assessing the creditworthiness of the entity. The process requires the analyst to make judgments about the future that are rooted in speculation. The "best guess" process has historical precedence which provides the analyst with a template to follow. Both the revenue generating and future asset values must be compared with the cost flows and debt burdens in order to accurately assess the future viability of the entity. The absence of a sovereign nation's cultural assets in the valuation process needs to be corrected to ensure the credit ratings assigned reflect the complete story. The lack of transparency in the ratings process has served to undermine the ability of academics to infuse real-life business examples into the curriculum. Currently, the real-life examples are being used primarily as a tool to illustrate a "what not to do" approach rather than as an example of how the international business community succeeds in the reporting process.<sup>1</sup>



Figure 1:

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