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Integration of ERM Analysis Into Corporate Credit Ratings

In May 2008, Standard & Poor's (S&P) formally announced they would begin to augment their meetings with rated companies in nonfinancial industry sectors to include discussions designed to elicit a better understanding of the status of enterprise risk management (ERM) programs and efforts at these companies. On July 22, 2009, S&P issued a progress report that discloses their findings to date and timeline for inclusion of specific ERM analyses within their corporate credit ratings reports. This brief article summarizes the S&P progress report.

The AICPA and the ERM Initiative faculty at NC State University have partnered to offer a two-day workshop, The Board and Senior Executive Roles in Risk Oversight: Taking a Strategic View of the Enterprise, Nov. 5–6 in New York, NY. This high-level forum provides attendees the latest on ERM and board and audit committee governance and strategic planning. Details: cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/PRDOVR~PC-AUDITCONF/PC-AUDITCONF.jsp

S&P analyst discussions of ERM have been focused in two areas: risk management culture and strategic risk management. These discussions have explored risk management program structures, roles of staff responsible for risk management activities, the communication of risk information within the organization and externally, and existing risk management policies and risk metrics. The S&P progress report states that enhanced focus on ERM is intended to provide a more effective structure for evaluating management — an evaluation that has always been an integral part of the credit ratings process.

The progress report states that S&P does not expect the focus on ERM will significantly change their existing processes for determining an appropriate rating. The report states:

> ". . . we [S&P] don't see ERM analysis radically altering our existing credit rating opinions. We expect its value to be incremental in many cases, negligible in a few, and eye-opening in some. We believe that this analysis will result in some rating and outlook changes once we have been able to benchmark companies against each other over time." *(emphasis added)*

To date, S&P has conducted more than 300 ERM discussions with rated companies — a number that represents approximately 10% of their global coverage for nonfinancial issuers. The discussions have centered on these questions:

- What are the company's top risks, how big are they, and how often are they likely to occur? How often is the list of top risks updated?
- What is management doing about top risks?
- What size quarterly operating or cash loss has management and the board agreed is tolerable?
- Describe the staff responsible for risk management programs and their place in the organization chart. How do you measure the success of risk-management activities?
- How would a loss from a key risk affect incentive compensation of top management and planning/budgeting?
- What discussions about risk management took place at the board level or among top management regarding past strategic decisions?
- Give an example of how your company responded to a recent "surprise" in your industry. How did the surprise end up affecting your company differently than have other surprises?

AUTHOR BIO

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As readers might imagine, S&P reports significant variation in the level of adoption, formality, maturity and engagement of ERM practices across the firms they have visited. One common theme: there have been few instances of a firm's ability to articulate a risk tolerance or risk appetite that has been defined for the organization. Another theme: firms' focus on managing downside risks with little, if any, attention paid to the opportunities ERM is designed to identify. These risky opportunities represent the competitive strengths of certain organizations that are able to make better risk-informed decisions and exploit risky opportunities for profit.

S&P's observations also confirm recent research conducted by the NC State University ERM Initiative, conducted on behalf of the AICPA's Business, Industry & Government team. (See "Report on the Current State of Enterprise Risk Oversight," available at aicpa.org/download/audcommctr/AICPA-Research-Study.pdf.)

This study finds, as has S&P in their conversations, that most risk management activities remain "silo-based" and at the operational managers' level. That is, true ERM is not yet a common practice in the organizations S&P has visited to date.

S&P reports that ERM programs most often have been executed by developing a new structure within the organization. The ERM function typically reports directly to the CFO or the CEO, often with a separate line of communication to the board of directors — most commonly to the audit committee of the board. S&P also reports that they have seen many examples of risk management structures with little stature and influence in their organizations. They also note that companies in industries that encounter more easily quantified risks are generally more comfortable in their ERM discussions with their S&P analyst(s). Such industries include energy, pharmaceuticals, agribusiness and some manufacturers.

S&P is committed to continuing this effort, and plans to publish a second progress report in late 2009. They also plan to, in 2010, initiate the inclusion of ERM assessment results as part of their corporate credit ratings reports. It is important that all potentially affected organizations stay abreast of S&P's ERM assessment efforts. It is likely they will continue to publish guidance with respect to their expectations for enterprise-level risk management and oversight. To ensure a positive experience if or when you are scheduled for an S&P analyst visit, it will be critically important to be prepared for questions related to risk management structure, status and evolution.

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